



## Report to Congressional Committees

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May 2018

# PUERTO RICO

## Factors Contributing to the Debt Crisis and Potential Federal Actions to Address Them



Highlights of [GAO-18-387](#), a report to Congressional Committees

## Why GAO Did This Study

Puerto Rico has roughly \$70 billion in outstanding debt and \$50 billion in unfunded pension liabilities and since August 2015 has defaulted on over \$1.5 billion in debt. The effects of Hurricanes Irma and Maria will further affect Puerto Rico's ability to repay its debt, as well as its economic condition. In response to Puerto Rico's fiscal crisis, Congress passed the Puerto Rico Oversight, Management, and Economic Security Act (PROMESA) in 2016, which included a provision for GAO to review Puerto Rico's debt.

This report describes the factors that contributed to Puerto Rico's financial condition and levels of debt and federal actions that could address these factors. Consistent with PROMESA, GAO focused on actions that would not increase the federal deficit.

To address these objectives, GAO reviewed documents and interviewed officials from the Puerto Rico and federal governments and conducted a review of relevant literature. GAO also interviewed former Puerto Rico officials and experts in Puerto Rico's economy, the municipal securities markets, and state and territorial budgeting, financial management, and debt practices, as well as officials from the Financial Oversight and Management Board for Puerto Rico (created by PROMESA).

GAO is not making recommendations based on the federal actions identified because policymakers would need to consider challenges and tradeoffs related to implementation.

The Puerto Rico government generally agreed with the factors we identified and provided additional information. GAO incorporated technical comments from SEC as appropriate.

View [GAO-18-387](#). For more information, contact Heather Krause at (202) 512-6806 or [krauseh@gao.gov](mailto:krauseh@gao.gov).

May 2018

## PUERTO RICO

### Factors Contributing to the Debt Crisis and Potential Federal Actions to Address Them

#### What GAO Found

The factors that contributed to Puerto Rico's financial condition and levels of debt relate to (1) the Puerto Rico government running persistent annual deficits—where expenses exceed revenues—and (2) its use of debt to cope with deficits. Based on a literature review and interviews with current and former Puerto Rico officials, federal officials, and other relevant experts, GAO identified factors that contributed to Puerto Rico's persistent deficits:

- **The Puerto Rico government's inadequate financial management and oversight practices.** For example, the Puerto Rico government frequently overestimated the amount of revenue it would collect and Puerto Rico's agencies regularly spent more than the amounts Puerto Rico's legislature appropriated for a given fiscal year.
- **Policy decisions by Puerto Rico's government.** For example, Puerto Rico borrowed funds to balance budgets and insufficiently addressed public pension funding shortfalls.
- **Puerto Rico's prolonged economic contraction.** Examples of factors contributing to the contraction include outmigration and the resulting diminished labor force, and the high cost of importing goods and energy.

Additional factors enabled Puerto Rico to use debt to finance its deficits, such as high demand for Puerto Rico debt. One cause of high demand was that under federal law, income from Puerto Rico bonds generally receives more favorable tax treatment than income from bonds issued by states and their localities.

Based on an assessment of relevant literature and input from current and former Puerto Rico officials, federal officials, and other relevant experts, GAO identified three potential federal actions that may help address some of these factors. GAO also identified considerations for policymakers related to these actions.

- **Modify the tax exempt status for Puerto Rico municipal debt.** Making interest income from Puerto Rico bonds earned by investors residing outside of Puerto Rico subject to applicable state and local taxes could lower demand for Puerto Rico debt. However, reduced demand could hinder Puerto Rico's ability to borrow funds for capital investments or liquidity.
- **Apply federal investor protection laws to Puerto Rico.** Requiring Puerto Rico investment companies to disclose risks with Puerto Rico bonds and adhere to other requirements could lower demand for the bonds. However, this action could also limit Puerto Rico's ability to borrow funds.
- **Modify the Securities and Exchange Commission's (SEC) authority over municipal bond disclosure requirements.** SEC could be allowed to require timely disclosure of materials—such as audited financial statements—associated with municipal bonds. Over the past decade, Puerto Rico often failed to provide timely audited financial statements related to its municipal bonds. Timely disclosure could help investors make informed decisions about investing in municipal bonds. However, a broad requirement could place additional burdens on all U.S. municipal issuers, such as the costs of standardizing reporting.

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## Abbreviations

|                          |   |
|--------------------------|---|
| 1940 Act                 | Investment Company Act of 1940                                |
| BEA                      | Bureau of Economic Analysis                                   |
| BLS                      | Bureau of Labor Statistics                                    |
| CDA                      | Continuing Disclosure Agreement                               |
| Census                   | U.S. Census Bureau  |
| COFINA                   | Puerto Rico Sales Tax Financing Corporation                   |
| Congressional Task Force | Congressional Task Force on Economic Growth in Puerto Rico    |
| FAFAA                    | Fiscal Agency and Financial Advisory Authority                |
| GDB                      | Government Development Bank for Puerto Rico                   |
| GDP                      | Gross Domestic Product  |
| GNP                      | Gross National Product  |
| Hacienda                 | Puerto Rico Department of Treasury                            |
| IRS                      | Internal Revenue Service                                      |
| OGP                      | Puerto Rico Office of Management and Budget                   |
| Oversight Board          | Financial Oversight and Management Board for Puerto Rico      |
| PPACA                    | The Patient Protection and Affordable Care Act                |
| PREPA                    | Puerto Rico Electric Power Authority                          |
| PROMESA                  | Puerto Rico Oversight, Management, and Economic Stability Act |
| SEC                      | Securities and Exchange Commission                            |
| SSI                      | Supplemental Security Income                                  |
| Treasury                 | U.S. Department of the Treasury                               |

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U.S. GOVERNMENT ACCOUNTABILITY OFFICE

May 9, 2018

The Honorable Lisa Murkowski  
Chairman  
The Honorable Maria Cantwell  
Ranking Member  
Committee on Energy and Natural Resources  
United States Senate

The Honorable Rob Bishop  
Chairman  
The Honorable Raul Grijalva  
Ranking Member  
Committee on Natural Resources  
House of Representatives

Puerto Rico has roughly \$70 billion in outstanding public debt and \$50 billion in unfunded pension liabilities and, since August 2015, has defaulted on over \$1.5 billion in debt payments. In a 2006 report, we highlighted Puerto Rico's weakening fiscal condition, noting that Puerto Rico had experienced a steady, decade-long increase in debt.<sup>1</sup> In 2014, we reported that Puerto Rico had accumulated debt representing a much larger share of personal income than in any U.S. state.<sup>2</sup>

In September 2017, Hurricanes Irma and Maria made landfall on Puerto Rico. The effects of these hurricanes, which caused loss of life, significant

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<sup>1</sup>GAO, *Puerto Rico: Fiscal Relations with the Federal Government and Economic Trends during the Phaseout of the Possessions Tax Credit*, GAO-06-541 (Washington, D.C.: May 19, 2006).

<sup>2</sup>GAO, *Puerto Rico: Information of How Statehood Would Potentially Affect Selected Federal Programs and Revenue Sources*, GAO-14-31 (Washington, D.C.: Mar. 4, 2014).

displacements, and substantial damage in Puerto Rico, will further affect Puerto Rico's ability to repay its debt, as well as its economic condition.<sup>3</sup>

In response to Puerto Rico's long-term fiscal crisis, Congress passed and the President signed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) in June 2016.<sup>4</sup> PROMESA established a structure for oversight of Puerto Rico's fiscal affairs and a process for Puerto Rico to restructure its debts. As required by PROMESA, in October 2017 we reported on public debt and fiscal issues in Puerto Rico and other territories.<sup>5</sup> We reported that Puerto Rico's total public debt outstanding per capita had almost doubled since fiscal year 2005, and that Puerto Rico's outlook on repaying its debt depended on the outcomes of its debt restructuring process.

PROMESA also included a provision for us to examine factors contributing to the debt crisis and federal actions for preventing a future one.<sup>6</sup> This report describes (1) the factors that contributed to Puerto Rico's financial condition and levels of debt and (2) federal actions that could address the factors that contributed to Puerto Rico's financial condition and levels of debt. Consistent with PROMESA, we focused on actions that would not increase the federal deficit.

To describe the factors that contributed to Puerto Rico's financial condition and levels of debt, we collected and reviewed Puerto Rico government documents on its financial condition and on its processes for budget development and execution, debt issuance, and financial management. We also conducted a literature review and collected data from a non-generalizable sample of 20 large bond prospectuses issued

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<sup>3</sup>Previous U.S. natural disasters such as Hurricane Katrina had significant adverse effects on the economies of the regions that they affected, including significant outmigration. In the year following Hurricane Katrina, the Gulf Coast experienced a number of challenges to the growth of its economy, including decreased gross state product, rise in unemployment, increased outmigration and decreased housing units, decline in personal income, and decline in state tax revenue. U.S. Department of Commerce, Economic and Statistics Administration, *The Gulf Coast: Economic Impact & Recovery One Year after the Hurricanes* (Washington, D.C.: Oct. 2006).

<sup>4</sup>Pub. L. No. 114-187, 130 Stat. 549 (June 30, 2016).

<sup>5</sup>GAO, *U.S. Territories: Public Debt Outlook*, [GAO-18-160](#) (Washington, D.C.: Oct. 2, 2017).

<sup>6</sup>PROMESA, § 410.

by Puerto Rico agencies and public corporations between 2000 and 2017.

To describe federal actions that could address the factors that contributed to Puerto Rico's financial condition and levels of debt, we reviewed documents from the U.S. Department of the Treasury (Treasury) and the Securities and Exchange Commission (SEC), and our past reports on Puerto Rico, and conducted a literature review. Consistent with the provision in PROMESA that was the statutory requirement for this work, we focused on actions that were non-fiscal in nature—that is, actions that would not increase the federal deficit.<sup>7</sup>

For both objectives, we also interviewed current Puerto Rico officials from several agencies—the Puerto Rico Department of Treasury (known by its Spanish name Hacienda), Government Development Bank for Puerto Rico (GDB), the Puerto Rico Office of Management and Budget (Spanish acronym OGP), Fiscal Agency and Financial Advisory Authority (FAFAA), and the Puerto Rico Electric Power Authority (PREPA). We also interviewed 13 former Puerto Rico officials that held leadership positions at Hacienda, GDB, or OGP, or a combination thereof. These former officials served between 1997 and 2016 for various gubernatorial administrations associated with the two political parties in Puerto Rico that held the governorship during that period. We also interviewed officials from Treasury, SEC, the Federal Reserve Bank of New York, and the Financial Oversight and Management Board for Puerto Rico (created by PROMESA). Additionally, we conducted another 13 interviews with experts on Puerto Rico's economy, the municipal securities markets, state and territorial budgeting and debt management—including credit rating agencies—and with select industry groups in Puerto Rico. We selected the experts we interviewed based on their professional knowledge closely aligning with our engagement objectives, as demonstrated through published articles, congressional testimonies, and

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<sup>7</sup>Consistent with PROMESA, we excluded from our scope actions that: (1) were fiscal in nature, (2) could be taken by the Puerto Rico government, (3) could infringe upon Puerto Rico's sovereignty and constitutional parameters, and (4) could imperil America's homeland and national security. We also omitted from our scope actions that could promote economic growth in Puerto Rico, as these actions address debt levels in Puerto Rico only indirectly, in that economic growth can increase a government's tax revenues and thus may limit or prevent indebtedness. A congressional task force report also already recommended actions for Congress, executive agencies, and the Puerto Rico government for fostering economic growth in Puerto Rico. See Congressional Task Force on Economic Growth in Puerto Rico, *Report to the House and Senate* (December 20, 2016).

referrals from agency officials or other experts. For additional details on our scope and methodology, see appendix I.

We conducted this performance audit from January 2017 to May 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

### Application of Federal Laws in Puerto Rico

Puerto Rico, which has approximately 3.3 million residents according to U.S. Census Bureau (Census) estimates, is the largest and most populous territory of the United States.<sup>8</sup> As a territory, Puerto Rico is subject to congressional authority, though Congress has granted it broad authority over matters of internal governance—notably, by approving Puerto Rico's constitution in 1952.<sup>9</sup> Individuals born in Puerto Rico are U.S. citizens and can migrate freely to the states.

Puerto Rico and its residents are generally subject to the same federal laws as the states and their residents, except in cases where specific exemptions have been made, such as with certain federal programs. For example, Puerto Rico residents generally have full access to Social Security and unemployment insurance; however, for some programs, such as Medicaid, federal funding in Puerto Rico is restricted as compared to funding in the states.<sup>10</sup>

Residents of Puerto Rico are exempt from paying federal income tax on income from sources in Puerto Rico.<sup>11</sup> Residents are required to pay federal income tax on income from sources outside of Puerto Rico. They are also required to pay federal employment taxes, such as Social

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<sup>8</sup>Census estimate as of July 1, 2017.

<sup>9</sup>Pub. L. No. 82-447, 66 Stat. 327 (July 3, 1952).

<sup>10</sup>For information on how certain federal programs and tax laws differ in Puerto Rico versus the states, see [GAO-14-31](#).

<sup>11</sup>26 U.S.C. §933.

Security and Medicare taxes, on their income regardless of where it was earned. Puerto Rico residents are also ineligible for certain federal tax credits.<sup>12</sup>

Corporations located in Puerto Rico are generally subject to the same federal tax laws as corporations located in a foreign country. Corporations in Puerto Rico are generally exempt from federal taxes on profits except as such profits are effectively connected to a trade or business in the states, and so long as those profits remain held outside of the states. Additionally, these corporations were subject to a withholding tax on certain investment income from the United States not connected to a trade or business. Under the 2017 Public Law 115-97, starting in 2018 U.S. corporations that are shareholders in foreign corporations, such as those organized under Puerto Rico law, generally do not owe tax on dividends received from those foreign corporations.<sup>13</sup> Prior to this law, dividend payments to U.S. corporate shareholders were considered taxable interest for the U.S. parent corporation.

Prior to 1996, a federal corporate income tax credit—the possessions tax credit—was available to certain U.S. corporations that located in Puerto Rico. In general, the credit equaled the full amount of federal tax liability related to an eligible corporation’s income from its operations in a possession—including Puerto Rico—effectively making such income tax-free.<sup>14</sup> In 1996, the tax credit was repealed, although corporations that

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<sup>12</sup>For example, residents of Puerto Rico are ineligible for the Earned Income Tax Credit, and are only eligible for the Child Tax Credit if they have three or more children.

<sup>13</sup>Pub. L. No. 115-97, § 14101(a), 131 Stat. 2054, 2189 (Dec. 22, 2017).

<sup>14</sup>The Tax Reform Act of 1976 established the possessions tax credit under section 936 of the Internal Revenue Code with the purpose of assisting U.S. possessions in obtaining employment-producing investments by U.S. corporations. The credit effectively exempted two kinds of income from U.S. taxation: 1) income from the active conduct of a trade or business in a possession, or from the sale or exchange of substantially all of the assets used by the corporation in the active conduct of such trade or business, and 2) certain income earned from financial investments in U.S. possessions or certain foreign countries, if they were generated from an active business in a possession, and were reinvested in the same possession.

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were existing credit claimants were eligible to claim credits through 2005.<sup>15</sup>

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## Puerto Rico's Economy and Labor Force

Puerto Rico's economy is in a prolonged period of economic contraction. According to data from Puerto Rico's government, Puerto Rico's economy grew in the 1990s and early 2000s. However, between 2005 and 2016—the latest year for which data were available as of March 1, 2018—Puerto Rico's economy experienced year-over-year declines in real output in all but two years, as measured by real gross domestic product (GDP). From 2005 to 2016, Puerto Rico's real GDP fell by more than 9 percent (from \$82.8 billion to \$75.0 billion in 2005 dollars).<sup>16</sup> Puerto Rico's gross national product (GNP) followed a similar pattern over the same period, declining by more than 11 percent from 2005 to 2016 (from \$53.8 billion to \$47.7 billion in 2005 dollars).<sup>17</sup> Figure 1 shows Puerto Rico's real GDP and GNP growth rates from 1991 through 2016.

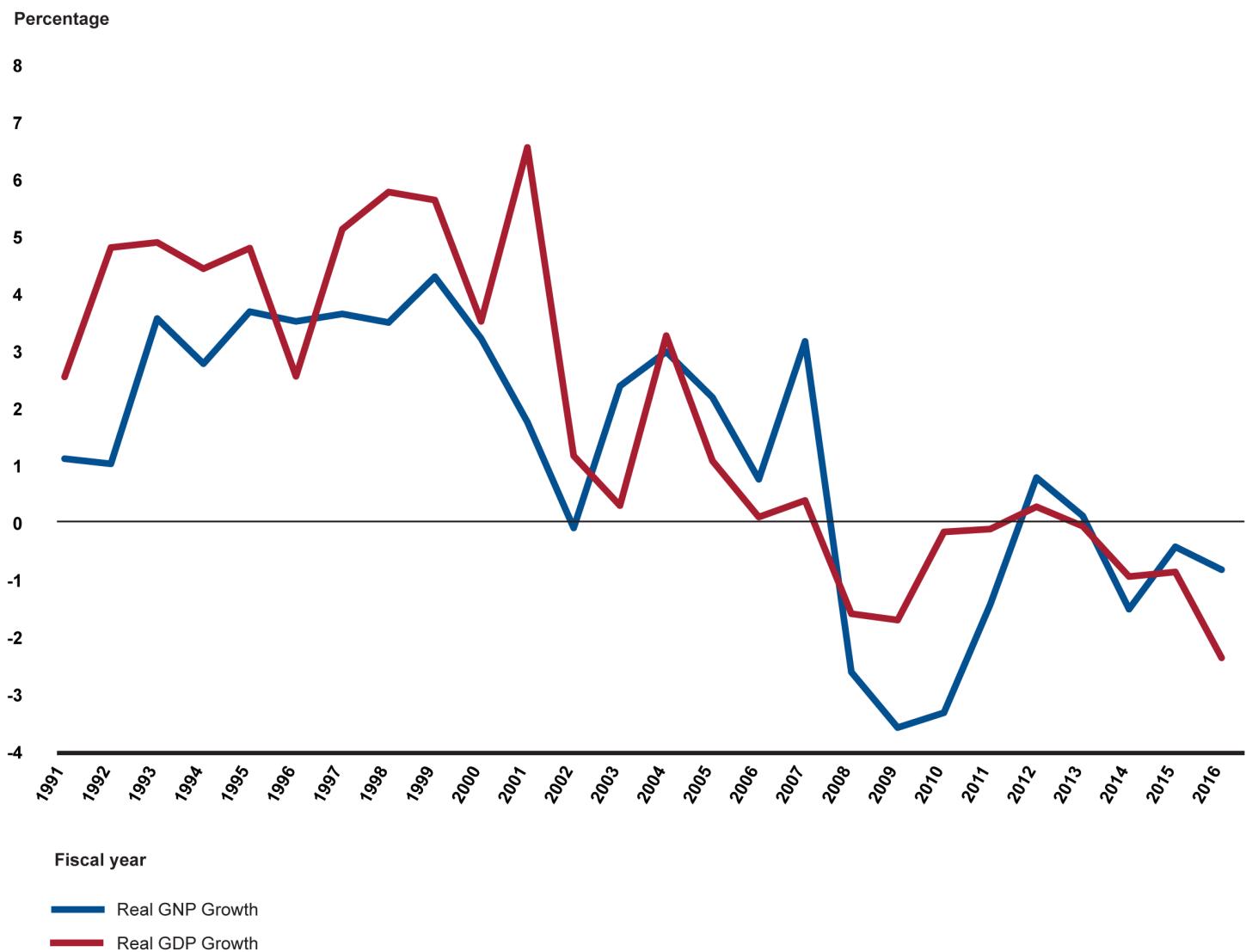
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<sup>15</sup>Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1601, 110 Stat. 1755, 1827–1833 (Aug. 20, 1996). The possessions tax credit was criticized on the grounds that the associated revenue cost was high compared to the employment it generated and because a large share of the benefits of the credit was not reaped by Puerto Rico residents.

<sup>16</sup>Real GDP and GNP data from Puerto Rico's Planning Board were provided in 1954 dollars, which we normalized to 2005 dollars. We did not independently verify the accuracy of the data. Many of the methods used by Puerto Rico's Planning Board for national economic accounts are outdated and do not follow the internationally agreed upon System of National Accounts standards. The System of National Accounts is the internationally agreed standard set of recommendations on how to compile measures of economic activity. In 2011, the U.S. Bureau of Economic Analysis (BEA) made a series of recommendations to improve Puerto Rico's national economic accounts and BEA provided assistance with this process.

<sup>17</sup>Puerto Rico's GDP measures the value of goods and services produced inside the territory, including production by foreign companies operating in Puerto Rico. In contrast, Puerto Rico's GNP measures the value of goods and services produced by Puerto Ricans regardless of where they live, and excludes production by foreign companies. In Puerto Rico, GDP has consistently been greater than GNP, which means that production by foreign companies in Puerto Rico is larger than production by Puerto Ricans living outside the territory.

**Figure 1: Real Gross Domestic Product (GDP) and Gross National Product (GNP) Growth in Puerto Rico**



Source: GAO analysis of Puerto Rico Planning Board Data | GAO-18-387

Note: GDP measures the value of goods and services produced inside a country, or for the purposes of this report, a territory. In contrast, GNP measures the value of goods and services produced by its residents. GNP includes production from residents abroad and excludes production by foreign companies in a country or territory. 2016 was the most recent year for which data were available as of March 1, 2018.

The decline in Puerto Rico's output has, in more recent years, occurred in conjunction with a decline in Puerto Rico's population. According to

Census estimates, Puerto Rico's population declined from a high of approximately 3.8 million people in 2004 to 3.3 million people in 2017, a decline of 12.8 percent.<sup>18</sup> This population loss closely matched the decline in real output. From 2004 to 2016, Puerto Rico's real GNP fell by 9.5 percent, while its real GNP per capita increased by 1.6 percent over the same time period.

In addition to Puerto Rico's declining population, the territory also has a lower share of employed persons compared to the United States as a whole. As of 2017, approximately 37 percent of Puerto Rico residents were employed compared to approximately 60 percent for the United States as a whole. Puerto Rico's employment-to-population ratio reached highs in 2005 and 2006 when it was approximately 43 percent, according to data from the Federal Reserve Bank of St. Louis. According to data from the Bureau of Labor Statistics (BLS), between 2005 and 2017, Puerto Rico's unemployment rate fluctuated between 10.2 percent and 17.0 percent, with an average of 13.1 percent. During the same period, the nationwide unemployment rate fluctuated between 4.1 percent and 10.0 percent, with an average of 6.5 percent. These factors have combined to leave Puerto Rico with a small and declining labor force. From January 2006 to December 2017—the latest month for which data were available as of March 1, 2018—Puerto Rico's labor force decreased from approximately 1.4 million persons to 1.1 million persons, according to data from BLS.

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#### Puerto Rico Government Financial Condition

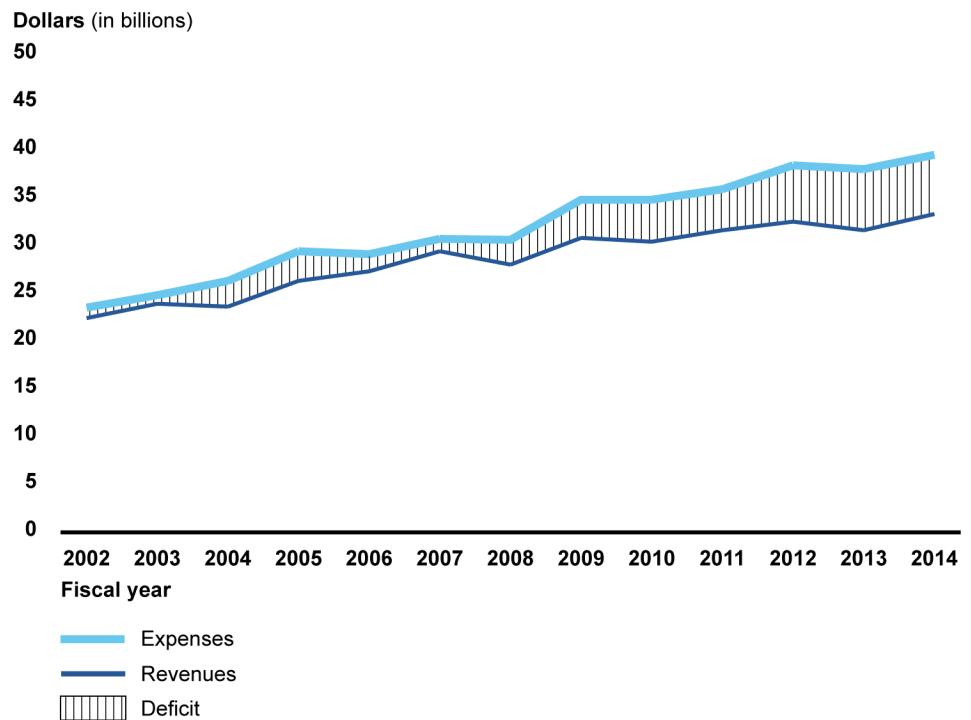
Puerto Rico's government has operated with a deficit—where expenses exceed revenues—in each fiscal year since 2002, and its deficits grew over time (see figure 2).<sup>19</sup>

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<sup>18</sup>This decline was prior to the effect of Hurricanes Irma and Maria in September 2017. Though it is still too early to know with certainty what the effect of the hurricanes will be on Puerto Rico's population, some experts believe that the hurricanes would likely accelerate Puerto Rico's population loss.

<sup>19</sup>Puerto Rico's fiscal year is from July 1 to June 30.

**Figure 2: Puerto Rico's Government Revenue and Expenses, Fiscal Years 2002 to 2014**



Source: GAO analysis of Puerto Rico's fiscal years 2002 to 2014 audited financial statements. | GAO-18-387

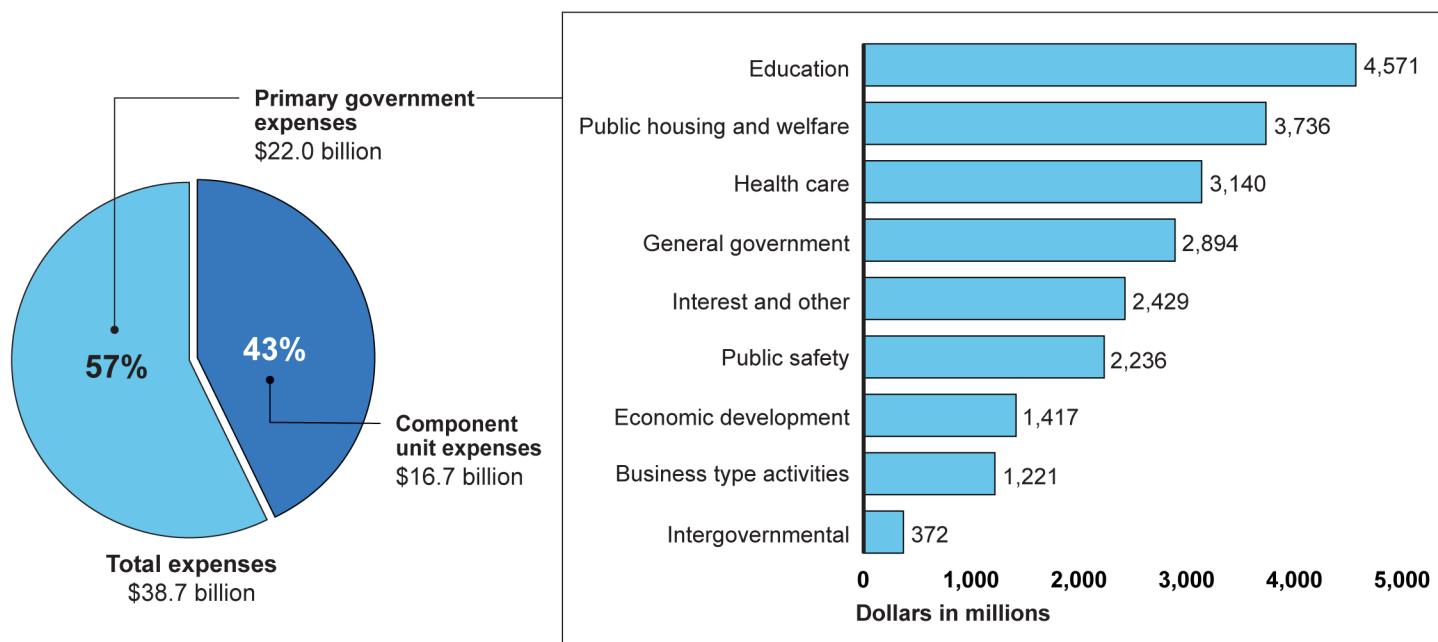
Note: Puerto Rico has not yet released its audited financial statements for fiscal years 2015, 2016, and 2017. According to current Puerto Rico officials, the Puerto Rico government plans to release its audited financial statements for fiscal years 2015 and 2016 by the end of June 2018. These officials also stated that the Puerto Rico government has not yet set a timeline for releasing audited financial statements for fiscal year 2017.

Puerto Rico's governmental activities can be divided among the primary government and component units. Puerto Rico's primary government provides and funds services such as public safety, education, health care, and economic development. Puerto Rico's component units are legally separate entities for which its government is nonetheless financially accountable, and provide services such as public transportation, highways, electricity, and water.<sup>20</sup>

<sup>20</sup>Unless otherwise noted, financial data on Puerto Rico's government refers to its primary government and component units combined.

In fiscal year 2014, the latest for which audited financial data are available, the Puerto Rico government collected \$32.5 billion in revenue, of which \$19.3 billion was collected by the primary government, and \$13.2 billion was collected by the component units. That year Puerto Rico's government spent \$38.7 billion, of which \$22.0 billion was spent directly by the primary government, while \$16.7 billion was spent by the government's various component units. The Puerto Rico Electric Power Authority (PREPA), which operates the territory's electricity generation and distribution infrastructure, represented the largest component unit expenditure in fiscal year 2014. Figures 3 and 4 show a breakdown of expenses for Puerto Rico's primary government and its component units, respectively.

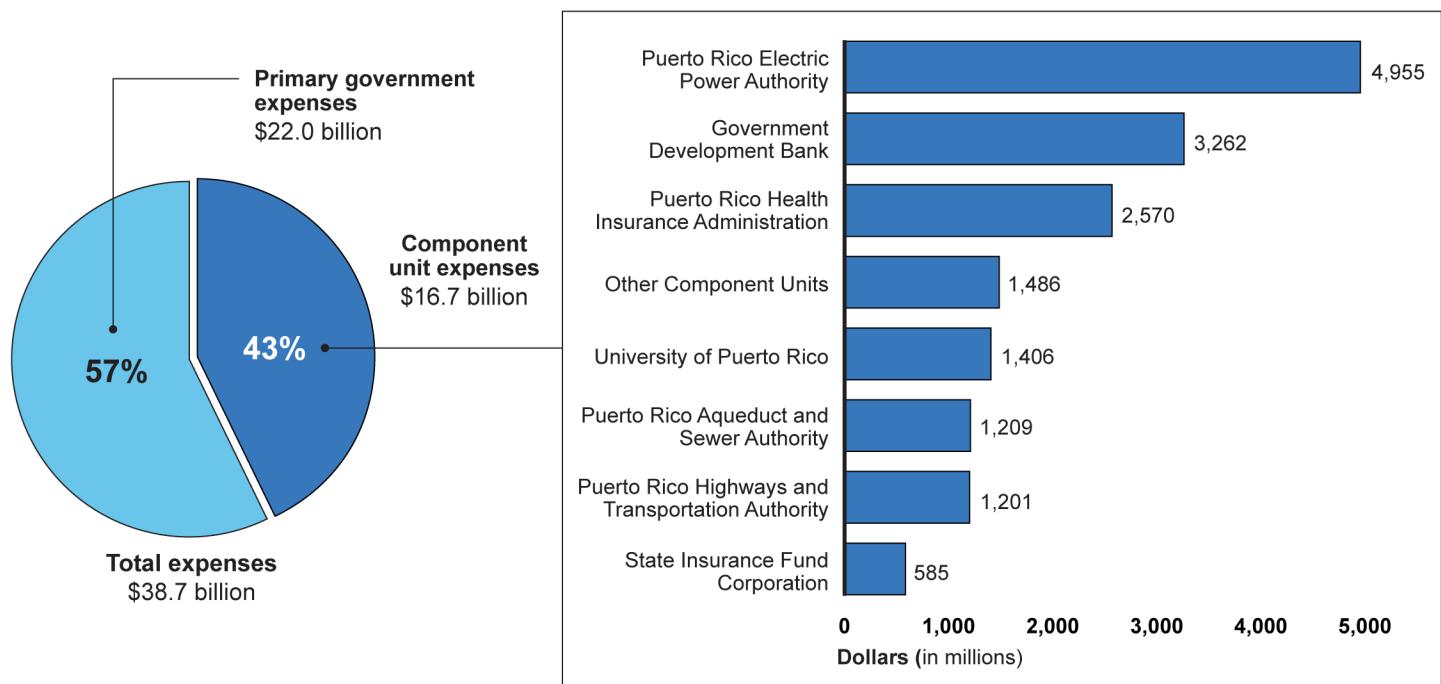
**Figure 3: Breakdown of Expenses for Puerto Rico's Primary Government, Fiscal Year 2014**



Source: GAO analysis of Puerto Rico's fiscal year 2014 audited financial statement. | GAO-18-387

Note: Puerto Rico has not yet released its audited financial statements for fiscal years 2015, 2016, and 2017. According to current Puerto Rico officials, the Puerto Rico government plans to release its audited financial statements for fiscal years 2015 and 2016 by the end of June 2018. These officials also stated that the Puerto Rico government has not yet set a timeline for releasing audited financial statements for fiscal year 2017.

Figure 4: Breakdown of Expenses for Puerto Rico's Component Units, Fiscal Year 2014



Source: GAO analysis of Puerto Rico's fiscal year 2014 audited financial statement. | GAO-18-387

Note: Puerto Rico has not yet released its audited financial statements for fiscal years 2015, 2016, and 2017. According to current Puerto Rico officials, the Puerto Rico government plans to release its audited financial statements for fiscal years 2015 and 2016 by the end of June 2018. These officials also stated that the Puerto Rico government has not yet set a timeline for releasing audited financial statements for fiscal year 2017.

Puerto Rico's government spending accounts for more than a third of the territory's GDP. In fiscal year 2014—the latest year for which audited spending data were available as of March 1, 2018—primary government expenditures of \$22.0 billion represented 21 percent of the territory's GDP. Including component spending, total public expenditures were \$38.7 billion, which represented 38 percent of the territory's GDP. By comparison, our prior work has shown that in 2014, total state and local government expenditures represented about 14 percent of GDP for the United States as a whole, excluding territories.<sup>21</sup> Federal government

<sup>21</sup>GAO, *Fiscal Outlook: State and Local Fiscal Model*, accessed February 27, 2018, [https://www.gao.gov/fiscal\\_outlook/state\\_local\\_fiscal\\_model/overview#t=1](https://www.gao.gov/fiscal_outlook/state_local_fiscal_model/overview#t=1).

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expenditures were 20 percent of GDP for the United States as a whole in 2014.

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### Puerto Rico Debt

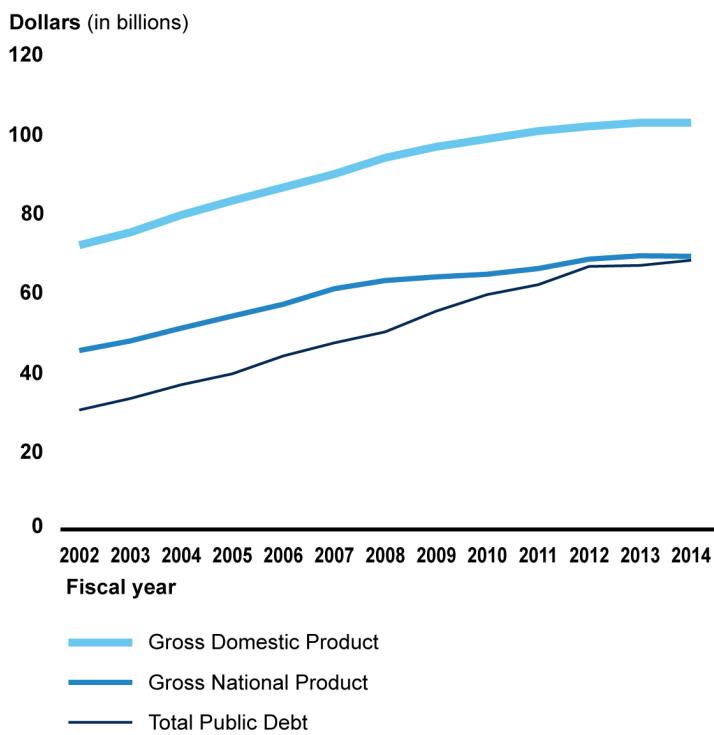
Puerto Rico's total public debt as a share of its economy has grown over time. In 2002, the value of its debt was 42 percent of the territory's GDP, and 67 percent of its GNP. Both of these ratios grew over time such that by 2014, Puerto Rico's total public debt was 66 percent of the territory's GDP and 99 percent of its GNP. Figure 5 compares Puerto Rico's total public debt to its GDP and GNP, in both aggregate and per capita.<sup>22</sup>

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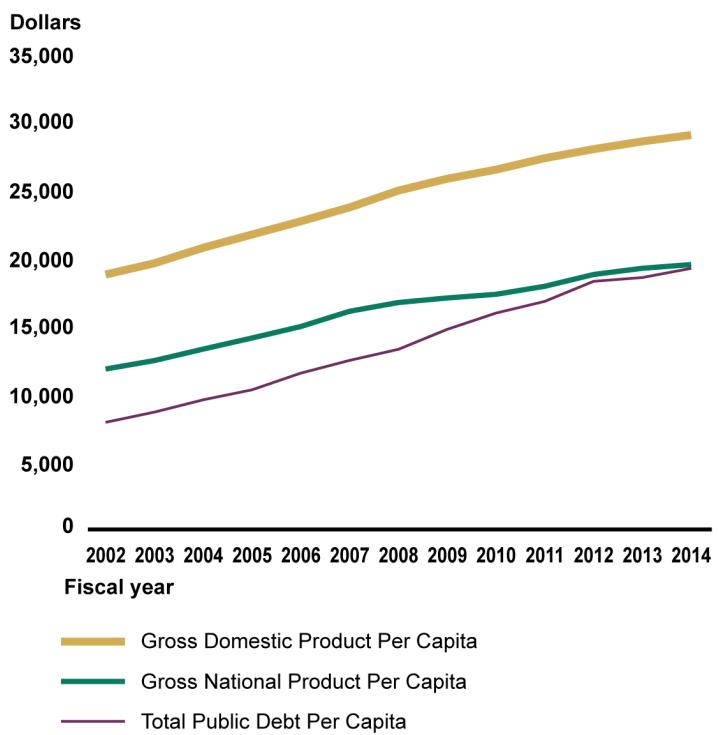
<sup>22</sup>For further detail on Puerto Rico's public debt between fiscal years 2005 and 2017, see [GAO-18-160](#).

**Figure 5: Puerto Rico's Public Debt, Gross Domestic Product (GDP), and Gross National Product (GNP), Fiscal Years 2002 to 2014**

Puerto Rico's GDP, GNP, and Total Public Debt



Puerto Rico's GDP Per Capita, GNP Per Capita, and Total Public Debt Per Capita

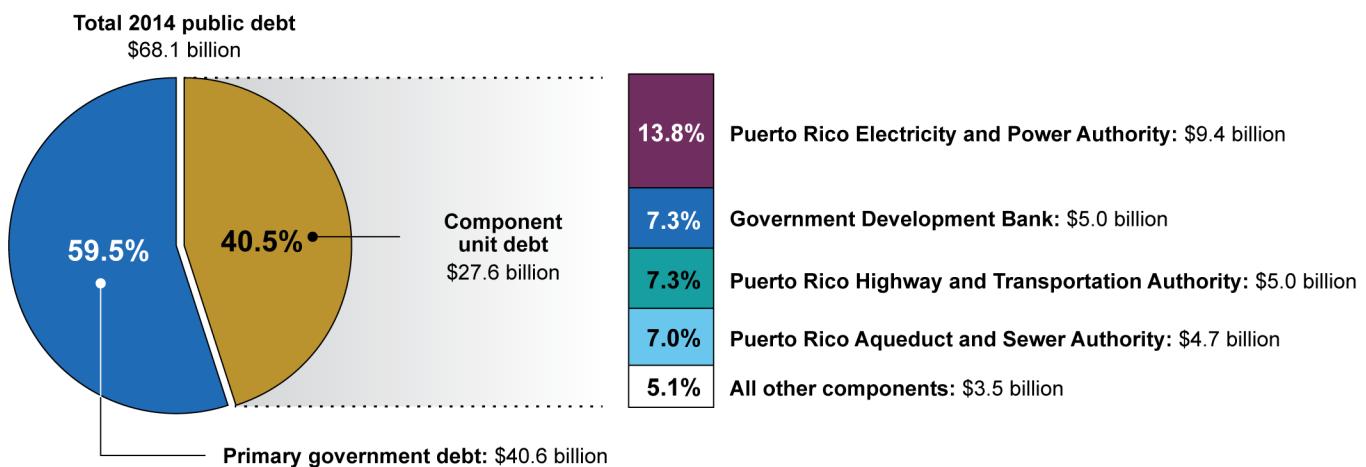


Sources: GAO analysis of Puerto Rico Planning Board and U.S. Census Bureau information. | GAO-18-387

Note: Puerto Rico has not yet released its audited financial statements for fiscal years 2015, 2016, and 2017. According to current Puerto Rico officials, the Puerto Rico government plans to release its audited financial statements for fiscal years 2015 and 2016 by the end of June 2018. These officials also stated that the Puerto Rico government has not yet set a timeline for releasing audited financial statements for fiscal year 2017.

As of the end of fiscal year 2014, the last year for which Puerto Rico issued audited financial statements, Puerto Rico had \$67.8 billion in net public debt outstanding, or \$68.1 billion excluding accounting adjustments that are not attributed in the financial statements to specific agencies. Of the \$68.1 billion, \$40.6 billion was owed by Puerto Rico's primary government, and \$27.6 billion was owed by its component units, as shown in figure 6 (these amounts do not sum to \$68.1 billion because of rounding).

Figure 6: Puerto Rico's Public Debt, Fiscal Year 2014



Source: GAO analysis of Puerto Rico's fiscal year 2014 audited financial statement. | GAO-18-387

Note: The \$68.1 billion in total gross public debt excludes about \$300 million in accounting adjustments that are not attributed in the financial statements to specific agencies; net public debt was \$67.8 billion. Primary government and component unit debt amounts do not sum to total public debt due to rounding. Puerto Rico has not yet released its audited financial statements for fiscal years 2015, 2016, and 2017. According to current Puerto Rico officials, the Puerto Rico government plans to release its audited financial statements for fiscal years 2015 and 2016 by the end of June 2018. These officials also stated that the Puerto Rico government has not yet set a timeline for releasing audited financial statements for fiscal year 2017.

The growth of Puerto Rico's total debt resulted in greater annual debt servicing obligations. In fiscal year 2002, it cost Puerto Rico \$2.7 billion to service its debt, representing about 12 percent of Puerto Rico's \$21.6 billion in total public revenue for that year. By fiscal year 2014, Puerto Rico's annual debt service cost rose to \$5.0 billion, representing just over 15 percent of Puerto Rico's \$32.5 billion in total public revenue for that year. Following years of expenditures that exceeded revenue, and a growing debt burden, in August 2015, Puerto Rico failed to make a scheduled bond payment. Since then, Puerto Rico has defaulted on over \$1.5 billion in debt.

In June 2016, Congress enacted and the President signed PROMESA in response to Puerto Rico's fiscal crisis. PROMESA established a Financial Oversight and Management Board for Puerto Rico (Oversight Board), and granted it broad powers of fiscal and budgetary control over Puerto Rico. PROMESA also established a mechanism through which the Oversight Board could petition U.S. courts on Puerto Rico's behalf to restructure debt. Under federal bankruptcy laws, Puerto Rico is otherwise prohibited

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from authorizing its municipalities and instrumentalities from petitioning U.S. courts to restructure debt. The Oversight Board petitioned the U.S. courts to restructure debt on behalf of Puerto Rico's Highways and Transportation Authority and the Government Employees Retirement System on May 21, 2017 and on behalf of PREPA on July 2, 2017.

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## Pension Obligations

In addition to its debt obligations, Puerto Rico also faces a large financial burden from its pension obligations for public employees. Puerto Rico's public pension systems had unfunded liabilities of approximately \$49 billion as of the end of fiscal year 2015, the most recent year for which data are available.<sup>23</sup> Unfunded pension liabilities are similar to other kinds of debt because they constitute a promise to make a future payment or provide a benefit.<sup>24</sup>

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## Officials and Experts Cited Various Factors as Contributing to Puerto Rico's Financial Condition and Levels of Debt

Based on interviews with current and former Puerto Rico officials, federal officials, and other relevant experts, as well as a review of relevant literature, the factors that contributed to Puerto Rico's financial condition and levels of debt related to: (1) Puerto Rico's government running persistent deficits and (2) its use of debt to cope with deficits.

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### Factors that Contributed to Puerto Rico's Persistent Deficits

As previously mentioned, Puerto Rico's government has operated with a deficit in all years since 2002, and deficits grew over time. To cope with its deficits, Puerto Rico's government issued debt to finance operations, rather than reduce its fiscal gap by cutting spending, raising taxes, or both. Through interviews with current and former Puerto Rico officials; federal officials; experts in Puerto Rico's economy, the municipal securities markets, and state and local budgeting and debt management; as well as a review of relevant literature, we identified three groups of

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<sup>23</sup>Puerto Rico also reported a \$2 billion of unfunded retiree medical liabilities at the end of fiscal year 2015. In general, U.S. states' and localities' pension plans face challenges over the long term due to the gap between assets and liabilities. See GAO, *State and Local Governments' Fiscal Outlook: 2016 Update*, GAO-17-213SP (Washington, D.C.: Dec 8, 2016).

<sup>24</sup>Financial economic theory informs the premise that a promise to make a future payment of benefits is similar to a promise to pay off any other kind of debt (such as a bond).

factors that contributed to Puerto Rico's persistent deficits: (1) inadequate financial management and oversight practices, (2) policy decisions, and (3) prolonged economic contraction. Some of the factors in these groups may be interrelated.

#### Inadequate Financial Management and Oversight Practices

According to current and former Puerto Rico officials and experts in Puerto Rico's economy and the municipal securities markets, Puerto Rico's government lacked adequate budgetary and other controls for effective financial management and oversight. This lack of effective practices and controls resulted in Puerto Rico's government: 1) overestimating the amount of revenue it would collect and 2) spending in excess of appropriated amounts.<sup>25</sup>

#### Overestimating Revenue Collection

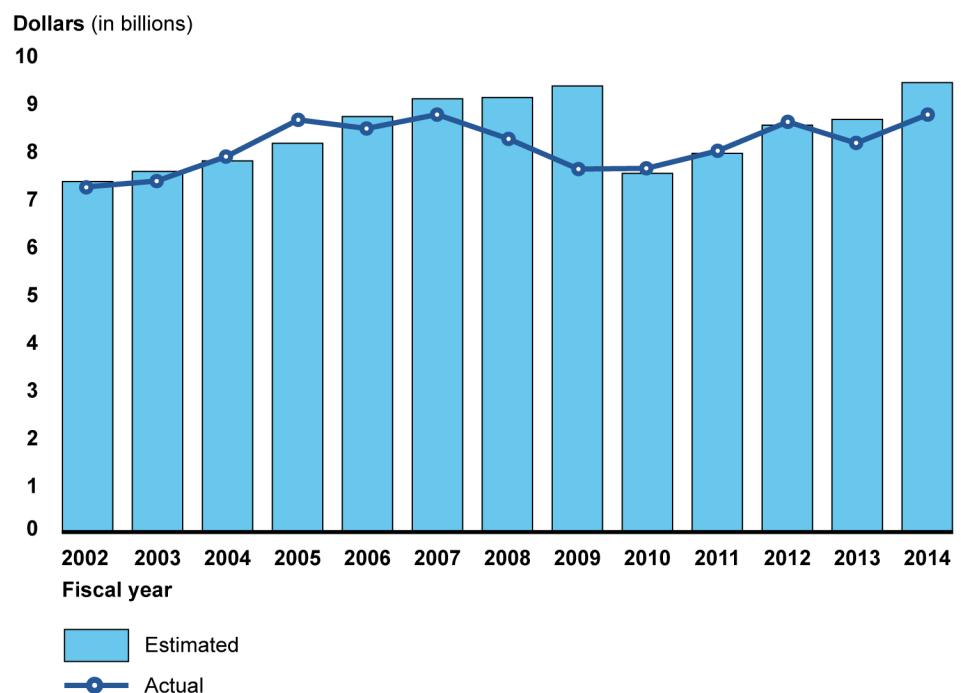
As part of its budget process the Puerto Rico government estimates the amount of revenues it will collect for the coming fiscal year, which informs how much the government then appropriates to agencies. Former Puerto Rico officials and experts in Puerto Rico's economy told us that when the Puerto Rico government developed its annual budget, it frequently overestimated the amount of revenues it would collect in the coming year. According to experts in state and local budgeting, revenue estimation is a complex process for any government and, in particular, during periods of recession. However, from our analysis of Puerto Rico's annual financial statements from 2002 to 2014, we found that Puerto Rico overestimated revenue in eight of thirteen years, as shown in figure 7. In certain fiscal years Puerto Rico overestimated revenues by a substantial amount. For

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<sup>25</sup>Puerto Rico may have other financial control deficiencies we did not explore in depth. For example, according to current Puerto Rico government officials, past practices of the Puerto Rico government indicate an insufficient understanding of liquidity within its agencies and public corporations. Puerto Rico's Fiscal Agency and Financial Advisory Authority (FAFAA) has been conducting a comprehensive evaluation of the cash balances of the Government of Puerto Rico and all of its instrumentalities, including some public corporations, and governmental agencies. On December 18, 2017, FAFAA released a report with the preliminary results of this evaluation, disclosing approximately \$6.9 billion in balances spread across 800 bank accounts. The Oversight Board has since hired an independent forensic analysis team to obtain a full account of the liquidity of the Puerto Rico government and all its instrumentalities and entities.

example, in fiscal years 2008 and 2009, Puerto Rico overestimated general fund revenue by 10 percent and 19 percent, respectively.<sup>26</sup>

**Figure 7: Puerto Rico's Estimated vs. Actual General Fund Revenues, Fiscal Years 2002 to 2014**



Source: GAO analysis of Puerto Rico's audited financial statements fiscal years 2002 - 2014. | GAO-18-387

Note: Puerto Rico has not yet released its audited financial statements for fiscal years 2015, 2016, and 2017. According to current Puerto Rico officials, the Puerto Rico government plans to release its audited financial statements for fiscal years 2015 and 2016 by the end of June 2018. The officials also stated that the Puerto Rico government has not yet set a timeline for releasing audited financial statements for fiscal year 2017.

<sup>26</sup>Puerto Rico's general fund is the main source of funding for Puerto Rico's primary government. The \$9.2 billion in general fund expenses for budgeted resources for fiscal year 2014 represented 42 percent of all primary government expenses of \$22 billion for that year. The U.S. economy as a whole was in recession for 2008 and much of 2009.

Overly optimistic revenue estimates allowed Puerto Rico's legislature—with approval from the governor—to increase appropriations to agencies in most years while also passing balanced budgets. When actual revenue fell short of the revenue estimates—and expenses were not adjusted accordingly—Puerto Rico's General Fund operated with a deficit. Absent adequate revenues or reserves to pay its expenses, Puerto Rico then issued debt.<sup>27</sup>

Current and former Puerto Rico government officials described various possible reasons why Puerto Rico overestimated revenue in its budget process.

- Departures from historical economic trends may have made it difficult for Puerto Rico to accurately project economic growth, a key variable Puerto Rico uses in estimating revenue. The Puerto Rico Planning Board has legal responsibility for preparing an annual economic report that includes economic growth projections. The Puerto Rico Department of Treasury (known by its Spanish name Hacienda) uses those projections to develop revenue estimates for the Governor's proposed budget, which Puerto Rico's legislature considers when adopting a final budget. According to former Puerto Rico government officials, the Planning Board historically has based its economic growth projections on projected U.S. economic growth and global oil prices. From 1990 through 2005, both Puerto Rico and the United States as a whole experienced similar economic growth, each growing by an average of between 3 and 3.5 percent per year during the same time period. However, since 2006 Puerto Rico's economy has performed worse than that of the United States as a whole. Also, oil prices rose in 2004 and remained at high levels until 2014, a change that the Planning Board did not foresee when developing its economic growth estimates. Current Puerto Rico officials also noted that population declines took place at a faster rate than expected, which they said led to less tax revenue than estimated.
- According to experts in state and local financial management, a best practice to limit political influence in the development of revenue estimates is to exclude elected officials from the estimation process. However, according to former Puerto Rico government officials, political actors were involved in the revenue estimating process. For

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<sup>27</sup>Sometimes state and local governments put a portion of their annual revenues into a reserve fund for future use—for example, to fund expenses when they experience revenue shortfalls.

example, some former officials told us that elected officials from the legislature exerted pressure on Hacienda to adopt optimistic revenue estimates.

According to a former Hacienda official and reports on Puerto Rico's fiscal situation, to entice corporate investment, Puerto Rico made agreements with specific corporations to reduce their tax rates.<sup>28</sup> The former official explained that Puerto Rico's government did not maintain a comprehensive inventory of these agreements, nor their terms and details, and as a result, Hacienda officials were unable to take these agreements into account when they estimated revenues.

Former Puerto Rico officials also told us that Hacienda sometimes factored into its revenue estimates expected revenue gains from measures designed to improve tax collection, for example targeted audit efforts or allocation of resources for tax administration. However, these measures did not always result in increased revenue, according to the former officials. Treasury officials and former Puerto Rico officials also told us that, in general, Puerto Rico had difficulty collecting tax revenue.

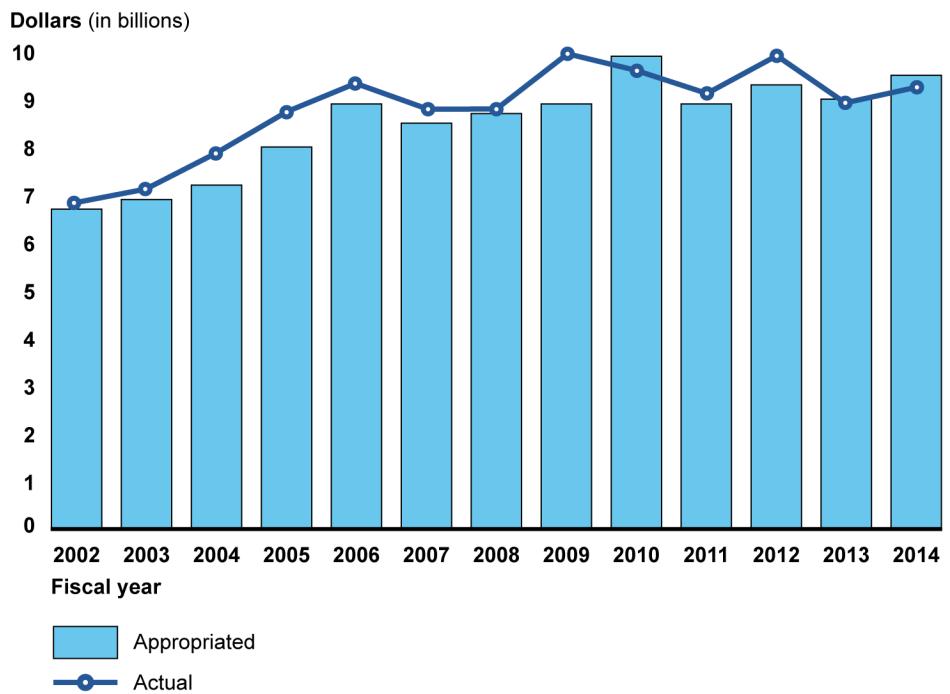
### **Persistent Spending in Excess of Appropriated Amounts**

Puerto Rico's agencies regularly spent more than the amounts Puerto Rico's legislature appropriated for a given fiscal year. From our analysis of Puerto Rico's annual financial statements, we found that Puerto Rico spent in excess of appropriated general fund amounts in nine of the thirteen most recent years for which data were available, as shown in figure 8. For the nine years when Puerto Rico spent in excess of appropriated amounts, actual spending exceeded appropriated amounts by an average of 5.6 percent, or \$459 million, annually.

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<sup>28</sup>Some states also make tax agreements with corporations to attract investment.

**Figure 8: Puerto Rico's Appropriated vs. Actual General Fund Expenses, Fiscal Years 2002 to 2014**



Source: GAO analysis of Puerto Rico's audited financial statements fiscal years 2002 - 2014. | GAO-18-387

Note: Puerto Rico has not yet released its audited financial statements for fiscal years 2015, 2016, and 2017. According to current officials, the Puerto Rico government plans to release its audited financial statements for fiscal years 2015 and 2016 by the end of June 2018. These officials also stated that the Puerto Rico government has not yet set a timeline for releasing audited financial statements for fiscal year 2017.

According to state and local budget experts, it is highly unusual for state government agencies to spend beyond appropriated amounts. According to current and former Puerto Rico officials and experts in state and local budgets, various factors contributed to Puerto Rico agencies spending in excess of appropriated amounts:

- Puerto Rico's government enabled its agencies to access additional funds without seeking additional appropriations. State and local budget experts told us that states typically require an agency at risk of exceeding its appropriation to go back to the legislature with clear justification to ask for a supplemental appropriation. Though a similar process exists in Puerto Rico, current and former Puerto Rico officials

told us that the Puerto Rico government worked with agencies to facilitate spending beyond appropriated amounts rather than requiring the agency to seek supplemental appropriations through the official process. According to other current Puerto Rico government officials, if an agency attempts to disburse funds in excess of its annual appropriation, the Puerto Rico Office of Management and Budget (Spanish acronym OGP) may deny its requests, or approve the funding by drawing down on a reserve account that is established annually as part of the budget process. In the latter instances, the agency must justify the additional expenses to OGP, and then OGP evaluates the request and funding available. According to current Puerto Rico government officials, OGP has written procedures to handle these requests, which are reviewed by a committee for final evaluation and approval. However, they did not provide us the procedures when we asked for them.

- Some of Puerto Rico's agencies' funds are not channeled through Hacienda accounts. Hacienda is in charge of managing cash, including collecting funds from, and disbursing funds to, agencies. OGP is charged with monitoring Puerto Rico agencies to ensure they do not spend more than is appropriated to them. Because funds for some Puerto Rico agencies are not channeled through Hacienda accounts, they are therefore not visible within OGP's and Hacienda's central accounting systems.<sup>29</sup> As a result, OGP and Hacienda could not directly monitor all agencies' accounts to track expenses and to verify the availability of appropriated funds, which limited their ability to control overspending at the agency level.
- The accounting systems some Puerto Rico agencies use are not compatible with OGP's and Hacienda's accounting systems. For example, Puerto Rico's Department of Health and Department of Education use newer versions of the accounting system currently in use at OGP and Hacienda. As a result, OGP and Hacienda at times must take extra steps to reconcile financial information from these agencies for reporting and oversight purposes, rather than through automated reporting functions within OGP and Hacienda systems. This reconciliation causes delays in accessing data, which may prevent officials within OGP and Hacienda from having comprehensive financial information in time to make informed financial decisions. For example, if officials do not have a complete

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<sup>29</sup>For example, according to current and former Puerto Rico government officials, funding for the Police Department (which comprises 9 percent of general fund expenses) was not channeled through Hacienda accounts, until recently.

and current record of revenues and expenses, they cannot monitor budgeted amounts versus actual expenditures, nor can they accurately anticipate budget overruns or revenue shortfalls to make mid-year budget adjustments.

- Former Puerto Rico officials told us that some agencies do not record invoices from, or process amounts due to, government vendors in the year the expenses are incurred because they do not have funds on hand to make payments after they exceed annually appropriated funds.<sup>30</sup> Instead, agencies save invoices to record as current expenses in the following year. This practice distorts expenses from year to year. According to current Hacienda officials, this practice occurs, in part, because the Puerto Rico government lacks a centralized accounts payable system to capture information from agencies and public corporations. Without this system, neither Hacienda nor other agencies know exactly how much the government owes to its suppliers.

## Policy Decisions

Former Puerto Rico officials; experts on Puerto Rico's economy, state and local budgeting, and debt management; and related literature cited policy decisions by Puerto Rico's government as one of the factors contributing to Puerto Rico's persistent deficits. Specific examples of policy decisions that either increased or sustained expenses or weakened revenue collection include: 1) allowing the use of debt proceeds to balance budgets, 2) insufficiently addressing public pension funding shortfalls, 3) inadequately managing PREPA's financial condition, and 4) expanding health care coverage.

- Allowing the use of debt proceeds to balance budgets.** Puerto Rico's government made decisions that contributed to the accumulation of unsustainable debt despite constitutional controls designed to prevent that occurrence. In 1974, Puerto Rico's Attorney General issued a broad interpretation of the balanced budget clause in Puerto Rico's constitution that allowed Puerto Rico to borrow funds

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<sup>30</sup>According to current Puerto Rico officials, Puerto Rico's agencies are responsible for receiving and approving invoices and vouchers for later payment by Hacienda.

through bond issuances to balance its budget.<sup>31</sup> In the following years, Puerto Rico's government chose to use bonds to balance Puerto Rico's budget.<sup>32</sup> According to experts in state and local budgeting, the use of long-term debt to address operating deficits is unusual. As we previously reported, ratings agencies described the use of debt to finance operations as a "red flag" in the case of Puerto Rico.<sup>33</sup> Further, in 2006, the Puerto Rico government created the Puerto Rico Sales Tax Financing Corporation (known by its Spanish acronym COFINA) as a means to issue bonds that originally was intended to repay debt, but by 2009 was used to finance operations. COFINA was backed by a new sales and use tax that the government

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<sup>31</sup>The legal framework for a balanced budget dates back to Section 34 of the 1917 Jones-Shafroth Act, which states that "No appropriation shall be made, nor any expenditure authorized by the legislature, whereby the expenditure of the Government of Porto Rico during any fiscal year shall exceed the total revenue then provided for by law and applicable for such appropriation or expenditure, including any available surplus in the treasury, unless the legislature making such appropriation shall provide for levying a sufficient tax to pay such appropriation or expenditure within such fiscal year." A provision in Puerto Rico's Constitution, which was approved in 1952, contains similar language in English: The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal year unless the imposition of taxes sufficient to cover said appropriations is provided by law. P.R. Const., art. VI, §7. The Spanish translation of the Constitution, however, translated revenues as "recursos" which can also be interpreted to mean resources. A 1974 ruling by Puerto Rico's attorney general clarified the legal meaning of "recursos" to a broader general definition of resources available to the government, including proceeds of bond issuances. P.R. Op. Sec. Just. 1974-15, 1974 WL, 326062, Opiniones del Secretario de Justicia de Puerto Rico, May 21, 1974.

<sup>32</sup>Both appropriation laws and laws authorizing the issuance of bonds have to be approved by the Puerto Rico legislature and signed by the Governor.

<sup>33</sup>GAO-18-160.

excluded from the calculation of debt when ensuring compliance with its constitutional debt limit.<sup>34</sup>

- **Insufficiently addressing public pension funding shortfalls.** Puerto Rico attempted to reform its public pension systems various times. However, these reforms were not followed by scheduled government contributions to pension plans and ultimately the reforms did not address funding shortfalls. In 2000, Puerto Rico shifted its public pension systems from a defined benefit to a defined contribution plan for newly hired employees in an attempt to reduce further growth in unfunded pension liabilities.<sup>35</sup> Though Puerto Rico's government no longer needed to make contributions to the defined benefit plan for newly hired employees who were under the defined contribution plan, they did not make scheduled contributions to fund pension liabilities for those hired prior to 2000. As a result, in 2008, Puerto Rico's Employees Retirement System—the largest of Puerto Rico's public pension systems—issued pension bonds to reduce the system's unfunded liabilities, fund benefit payments, and invest the bond proceeds. According to a former Puerto Rico official, the investments did not produce expected gains. In 2011 and 2013, the Puerto Rico government enacted additional reform of the Employees Retirement System to address its deteriorating solvency, including such changes as increased statutory rates for employer contributions,

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<sup>34</sup>In 1961 Puerto Rico amended its constitution to include a limit on debt service payment at 15 percent of average annual internal revenue. Internal revenue in Puerto Rico mainly includes income, property, and excise taxes. The language of the 1961 amendment notes that the borrowing limit applies to "bonds or notes for the payment of which the full faith credit and taxing power of the Commonwealth shall be pledged." General obligation bonds are issued by the Puerto Rican government, payable from its general funds, and are said to carry the full faith and credit of Puerto Rico. Revenue bonds do not explicitly carry the full faith and credit of Puerto Rico, but are instead tied to specific agencies and revenue sources. According to a description of public debt provided by GDB, sales and use tax revenues pledged for COFINA debt are excluded from the government's definition of available resources for payment of debt service, although this characterization has been challenged in recent litigation. See e.g., Lex Claims, LLC v. Fin. Oversight & Mgmt. Bd., 853 F.3d 548 (1<sup>st</sup> Cir. 2017). A portion of the tax generated through COFINA is used to repay COFINA debt.

<sup>35</sup>In defined benefit plans, workers' benefits are typically calculated using a formula that includes the number of years an employee has worked for an employer and, often, the employee's earnings in years prior to retirement. In defined contribution plans, workers accumulate savings through contributions to an individual account.

increased employee contributions, and an increased retirement age for participants.<sup>36</sup>

Puerto Rico's public pension systems remain largely unfunded. As of the end of fiscal year 2015, the most current year for which complete data are available, Puerto Rico's public pension systems had assets of \$777 million out of a total pension liability of \$49.6 billion.<sup>37</sup> Puerto Rico's resulting public pension system funding ratio (the ratio of assets to liabilities) of 1.6 percent for that year was very low, compared to the average ratio of 72 percent for public employee pension systems in the states.<sup>38</sup>

- **Inadequately managing PREPA's financial condition.** According to current and former Puerto Rico government officials and experts on Puerto Rico's economy, a number of decisions negatively affected PREPA's financial condition. First, PREPA did not update or improve its electric generation and transmission systems, which hampered their performance and led to increased production costs. Likewise, PREPA did not fully pass on cost increases to consumers. PREPA has not adjusted its base rate, designed to cover PREPA's operating expenses and debt service, since 1989.<sup>39</sup> To cope with cost increases, PREPA issued debt to finance operations rather than increase the base rate costs to consumers, according to current and former Puerto Rico officials.

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<sup>36</sup>According to a 2013 report by the Government Development Bank for Puerto Rico, absent reform, the retirement system's assets would have been depleted by fiscal year 2019, and the government and other employers would have been required to provide funds to make up for subsequent cash funding shortfalls. GDB projected that the retirement system's gross assets would no longer be depleted after reforms. See Government Development Bank for Puerto Rico, *Commonwealth of Puerto Rico, Financial Information and Operating Data Report* (Puerto Rico: Oct. 18, 2013).

<sup>37</sup>Government Development Bank for Puerto Rico, *Commonwealth of Puerto Rico, Financial Information and Operating Data Report* (Puerto Rico: Dec. 18, 2016). Reports for Puerto Rico's three public pension systems were not available for 2017, as of March 1, 2018. For 2016, net pension liabilities for the Teacher's Retirement System and Judiciary Retirement System increased from 2015 by \$2.3 billion and \$74 million, respectively. Data for the Public Employees Retirement System were not available for 2016.

<sup>38</sup>For funding ratio for state public employee pension plans for 2015, see Pew Charitable Trust: *Measuring the Fiscal Health of State Pension Plans*, accessed January 16, 2018, <http://www.pewtrusts.org/en/research-and-analysis/analysis/2017/07/19/measuring-the-fiscal-health-of-state-pension-plans>.

<sup>39</sup>PREPA charges consumers based on three rates: 1) a base rate designed to cover operating expenses and debts, 2) an adjustment charge for fluctuations in fuel expenses, and 3) a purchased power charge. PREPA passes through both the fuel adjustment and purchased power charges to customers on a monthly basis.

- **Expanding health care coverage.** Puerto Rico residents that meet certain eligibility criteria can qualify for Medicaid. Puerto Rico has historically opted to insure some categories of individuals that it is not required to cover under federal law to receive matching federal Medicaid funding.<sup>40</sup> Depending on the category of individual, Puerto Rico partially or solely paid for the additional coverage.<sup>41</sup> Likewise, federal funding for Puerto Rico's Medicaid program is lower than what it would be if Puerto Rico were treated in the same way as the states—for example, its statutory federal matching rate is lower than it would be if it were a state.<sup>42</sup> In 2014, we estimated that if Puerto Rico had been treated as a state in 2011, federal spending on Medicaid in Puerto Rico would have ranged from \$1.1 billion to \$2.1 billion, as compared to actual federal spending of \$685 million.<sup>43</sup>

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<sup>40</sup>To determine Medicaid eligibility, Puerto Rico uses a local poverty level, which is lower than the federal poverty level used by states.

<sup>41</sup>As in the states, Puerto Rico must provide coverage to certain mandatory categories of individuals to qualify for matching federal Medicaid contributions and may cover optional categories of individuals and qualify for additional matching federal Medicaid contributions. Historically, Puerto Rico has extended Medicaid coverage to certain optional categories of individuals. Also, prior to the enactment of the Patient Protection and Affordable Care Act (PPACA), Puerto Rico solely funded health care coverage for other categories of individuals that were not eligible for Medicaid, such as certain childless, non-elderly, non-disabled adults. PPACA allowed Puerto Rico to extend Medicaid eligibility to such adults who met income eligibility criteria.

<sup>42</sup>Puerto Rico's federal matching assistance percentage for Medicaid is set by statute at 55 percent. 42 U.S.C. § 1396(b). The federal share would be 83 percent if it were calculated in the same way as for the states. Also, the federal contribution to Puerto Rico's Medicaid program generally is limited by statute, although additional funding above this limit has been provided in the past. See 42 U.S.C. § 1308. PPACA authorized a \$6.3 billion increase in Medicaid funding for the territories between July 1, 2011, and September 30, 2019. In [GAO-14-31](#), we reported that Puerto Rico qualified for \$5.5 billion of this additional funding, according to the Centers for Medicare and Medicaid Services. The Consolidated Appropriations Act, 2017, provided an additional \$296 million in Medicaid funding for Puerto Rico. 42 U.S.C. § 1308(g)(5)). Any unobligated funds of the \$5.5 billion from PPACA were rescinded through this Act. Additionally, the Bipartisan Budget Act of 2018 authorized a \$3.6 billion increase in Medicaid funding for Puerto Rico, through September 30, 2019, and Puerto Rico can also receive another \$1.2 billion if it meets certain conditions related to data reporting and program integrity. The Act also increased the federal share of Medicaid spending in Puerto Rico to 100 percent during the period through which additional Medicaid funds are available.

<sup>43</sup>[GAO-14-31](#).

## Prolonged Economic Contraction

As described previously, Puerto Rico's economy is in a prolonged period of economic contraction. Hurricanes Irma and Maria have further stressed Puerto Rico's economy. Federal officials, current and former Puerto Rico officials, and other experts on Puerto Rico's economy we interviewed told us that Puerto Rico's struggling economy has contributed to its recurring deficit and the resulting debt crisis.<sup>44</sup> Through interviews with these officials and experts, and a literature review, we identified five main factors that have contributed to Puerto Rico's weak economic performance: 1) Puerto Rico's outmigration and diminished labor force, 2) regulatory challenges of doing business in Puerto Rico, 3) the high cost of importing goods and energy, 4) the phaseout of the possessions tax credit, and 5) banking and housing struggles. Some factors are internal to Puerto Rico, while other factors relate to the effect of federal policies on Puerto Rico.

### **Puerto Rico's Outmigration and Diminished Labor Force**

Current and former Puerto Rico government officials and other experts on Puerto Rico's economy told us that Puerto Rico's outmigration has been a cause and effect of Puerto Rico's economic struggles. They told us that when confronted with Puerto Rico's struggling economy, many of Puerto Rico's capable workers left Puerto Rico for work opportunities elsewhere in the United States. Current Puerto Rico officials also described outmigration as the result of disparate treatment under federal laws and programs, as Puerto Rico residents are able to migrate to the states and, upon moving, may newly qualify for additional federal benefits.<sup>45</sup> This outmigration, in addition to other demographic changes and workforce characteristics, has left Puerto Rico with a diminished workforce.

As previously mentioned, Puerto Rico's population and labor force have both been declining since 2005. Though negative net migration has persisted since the late-1990s, starting in 2005 annual negative net

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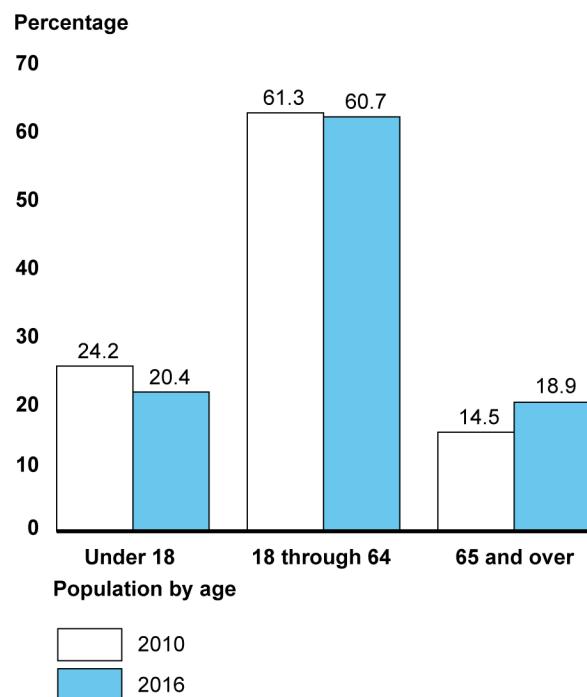
<sup>44</sup>We previously reported that, in general, state and local tax revenue increases during periods of economic expansion and decreases during periods of economic contraction. See GAO, *State and Local Governments: Knowledge of Past Recessions Can Inform Future Federal Fiscal Assistance*, GAO-11-401 (Washington, D.C.: Mar. 31, 2011).

<sup>45</sup>For example, a Puerto Rico resident could move to a state and newly qualify for Supplemental Security Income (SSI), a federal program that provides monthly cash assistance to people who are disabled, blind, or age 65 or over and lack sufficient income and resources to maintain a standard of living at the established federal minimum income level. Currently, Puerto Rico residents are not eligible for SSI, although they are eligible for a similar program that provides much smaller monthly benefits. See GAO-14-31.

migration in Puerto Rico grew significantly, finally outpacing the territory's natural population growth and leading to net population declines.

Puerto Rico's population has also been aging over this time period, meaning that there are proportionally fewer individuals of working age. According to Census data, between 2010 and 2016, the share of Puerto Rico residents under the age of 18 fell by about 4 percentage points, while the share of Puerto Rico residents over the age of 65 grew by about 4 percentage points, as shown in figure 9.

**Figure 9: Puerto Rico's Population by Age Group, 2010 versus 2016**



Source: GAO analysis of U.S. Census Bureau information. | GAO-18-387

Puerto Rico's changing demographics may have contributed to lower labor force participation; however, low labor force participation rates have persisted since the 1970s. We previously reported possible explanations for the low labor force participation rates, including that a relatively large

share of Puerto Rico residents work in the informal, or underground, economy.<sup>46</sup>

### **Regulatory Challenges of Doing Business in Puerto Rico**

Former Puerto Rico officials and experts on Puerto Rico's economy cited the high cost to businesses of complying with Puerto Rico regulations and federal laws as one possible reason for Puerto Rico's weak economic performance. Specifically, some experts on Puerto Rico's economy cited the Puerto Rico government's burdensome regulations and permitting processes for new businesses, and the associated costs of complying with the permitting process as a challenge. Local regulations pertaining to other worker benefits, such as overtime and paid leave, also raise the costs of hiring employees in Puerto Rico.

Experts on Puerto Rico's economy also told us that the federal minimum wage potentially reduced employment in Puerto Rico, though there was some disagreement among experts as to whether or not the federal minimum wage contributed significantly to Puerto Rico's economic struggles.<sup>47</sup> Some told us that the minimum wage made Puerto Rico a more expensive place to do business than other nearby locations, such as the Dominican Republic. Other experts told us that lowering the federal minimum wage would not help Puerto Rico's economy, given that if the minimum wage were lower than in the states, many more workers would leave Puerto Rico for the states.

Former Puerto Rico officials and experts on Puerto Rico's economy told us businesses looking to avoid either minimum wage requirements or the burdens of complying with Puerto Rico government taxes and regulations may have opted to hire workers from the informal labor market to bypass these regulations. By its very nature, it is difficult to measure the size and scope of informal economies, but because of the unrecognized

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<sup>46</sup>See [GAO-06-541](#). The informal, or underground, economy refers to economic activity that is not captured by official government records and thus is not reflected in national income and labor market statistics.

<sup>47</sup>Workers in Puerto Rico are subject to the same \$7.25 per hour federal minimum wage as workers in the states; however, typical wages in Puerto Rico are much lower than those in the states. According to Census data, as of 2016, Puerto Rico's median annual income was \$20,078. This was less than half the median income of the lowest income state (Mississippi), which had a median annual income of \$41,754. In March 2017, Puerto Rico's Governor signed an executive order raising the minimum wage for central government workers from \$7.25 to \$8.25 an hour.

contributions of this sector, some experts on Puerto Rico's economy told us that Puerto Rico's economy was not struggling as much as the official numbers suggested.<sup>48</sup> Still, because the government is not collecting income taxes from these workers, the informal economy affects Puerto Rico's ability to generate revenues and fund government services.

### **High Cost of Importing Goods and Energy**

As an island, many of the goods consumed in Puerto Rico need to be shipped in, which can significantly increase the cost of such goods. This constraint affects not only consumer goods, but also intermediary goods, which adds to the cost of doing business in Puerto Rico. Experts on Puerto Rico's economy we spoke with told us that the high cost of goods on the island may hinder the territory's economy by deterring businesses, which may target other locations where operating costs are lower.

Current and former Puerto Rico government officials and other experts on Puerto Rico's economy told us that the Jones Act raised the cost of importing goods, including oil, to Puerto Rico, and likely had a negative effect on Puerto Rico's economy.<sup>49</sup> The Jones Act requires that maritime transport of cargo between ports in the United States be carried by vessels that are owned by U.S. citizens and registered under the U.S. flag. The law further requires that such vessels be built in the United States and manned by predominantly U.S. citizen crews. According to current and former Puerto Rico officials, and other experts on Puerto Rico's economy, complying with this law raised the cost of goods and energy—given Puerto Rico's reliance on importing oil to generate electricity—for businesses operating in Puerto Rico.

Current and former Puerto Rico government officials and experts on Puerto Rico's economy we spoke with, as well as literature we reviewed, identified electricity as one good whose high cost was particularly consequential to Puerto Rico's economic struggles. Figure 10 shows that

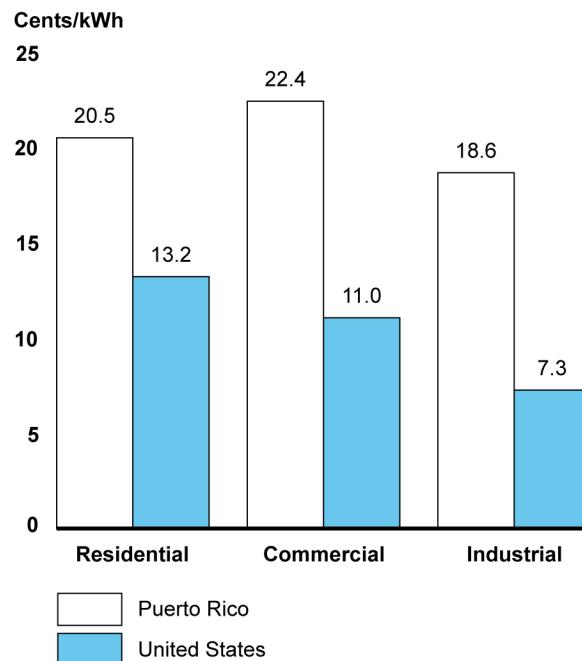
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<sup>48</sup>These discussions occurred prior to Hurricanes Irma and Maria. The long-term effects of these hurricanes on Puerto Rico's formal and informal economy are still uncertain.

<sup>49</sup>Section 27 of the Merchant Marine Act of 1920, Pub. L. No. 66-261, 41 Stat. 988, 999 (June 5, 1920), *codified, as amended*, at 46 U.S.C. § 55102. We previously reported on the possible effects of modifying the application of the Jones Act in Puerto Rico and found that the effects of any modification would be highly uncertain, and that various trade-offs could materialize depending on how the Act was modified. See GAO, *Puerto Rico: Characteristics of the Island's Maritime Trade and Potential Effects of Modifying the Jones Act*, GAO-13-260 (Washington, D.C.: Mar. 4, 2013).

average electricity prices in Puerto Rico for residential, commercial, and industrial customers were significantly higher than the U.S. average, and this difference was most pronounced for commercial and industrial uses.<sup>50</sup> The overall difference between Puerto Rico's electricity prices and the U.S. average was even greater in recent years when the price of oil was higher. For example, in 2011, the average retail price for Puerto Rico was 27.9 cents per kilowatt hour, which was more than two and a half times the U.S. average of 9.9 cents per kilowatt hour.

**Figure 10: Average Electricity Prices in Puerto Rico and the United States, August 2017**



Source: U.S. Energy Information Administration. | GAO-18-387

One reason that electricity is more expensive in Puerto Rico is that Puerto Rico uses petroleum as its primary source of energy to generate its electricity. According to the U.S. Energy Information Administration, in 2016, energy from petroleum made up 47 percent of Puerto Rico's electricity, followed by 34 percent from natural gas, 17 percent from coal,

<sup>50</sup>In 2017, Puerto Rico had higher retail electricity prices than any state, other than Hawaii.

and 2 percent from renewable sources. This reliance on petroleum makes Puerto Rico's electricity prices particularly vulnerable to fluctuations in oil prices in the international markets. Even when global oil prices fell, as they did in recent years, Puerto Rico's electricity remained expensive for a number of reasons. For example, as previously discussed, many of Puerto Rico's electrical plants do not utilize the most up-to-date technology, which makes them less efficient, and drives up costs.<sup>51</sup>

### **Phaseout of the Possessions Tax Credit**

Some current and former Puerto Rico government officials and other experts on Puerto Rico's economy we spoke with cited the phaseout of the possessions tax credit as a potential cause of Puerto Rico's economic struggles; however, there was no consensus as to the magnitude of its effect.<sup>52</sup> Some former officials and experts told us that the coincidence of the end of the phaseout period and the start of Puerto Rico's economic contraction, in 2006, was evidence that the phaseout led to the contraction. However, other former officials and experts noted that the phaseout of the credit occurred over a 10 year period, but Puerto Rico's economy continued growing through 2005. Others noted that the phaseout coincided with the growth of globalization, and that even with the tax credit, Puerto Rico's manufacturing sector may still have not been competitive with manufacturing in other parts of the world, such as East Asia.

According to Internal Revenue Service (IRS) Statistics of Income data, prior to the phaseout, in 1995, there were 440 companies that filed for the possessions tax credit, reporting over \$40 billion in gross income. Among these companies, manufacturing firms in Puerto Rico employed over 100,000 workers, who earned approximately \$2.7 billion in compensation, according to the estimates. By 2005, the final year of the phaseout period, 157 companies filed for the credit, reporting \$18 billion in gross income.

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<sup>51</sup>PREPA's January 2018 draft energy sector transformation plan includes goals of achieving low-cost energy and increasing generation from renewable sources.

<sup>52</sup>In 2006, we reported that U.S. corporations claiming the possessions tax credit dominated Puerto Rico's manufacturing sector into the late 1990s and that after the tax credit began to phase out in 1996, the activity of these corporations decreased significantly. We also reported that a variety of data indicated that much of the decline in corporations taking advantage of the credit was offset by growth in other corporations, so that some measures of aggregate activity remained close to their 1997 levels.

Companies taking advantage of the possessions tax credit provided Puerto Rico with capital. For example, in a 1993 report, we found that companies that claimed the credit provided Puerto Rico with between \$9 billion and \$10 billion in financial institution deposits between 1984 and 1991.<sup>53</sup> Puerto Rico's government provided incentives for these companies to keep their cash in Puerto Rican banks in order to avoid paying taxes to Puerto Rico. This arrangement provided capital that could be used for economic development within Puerto Rico. Several experts that we spoke with told us Puerto Rico is undercapitalized, which makes it difficult for businesses to develop. In addition, the effect of Hurricanes in September 2017 caused significant damage to physical capital in Puerto Rico.

### **Banking and Housing Struggles**

Current and former Puerto Rico officials and experts on Puerto Rico's economy told us that Puerto Rico's prolonged economic struggles have been, in part, exacerbated by struggles in Puerto Rico's banking and housing sectors. According to data from the Federal Housing Finance Agency, Puerto Rico's housing prices peaked in 2009, but have since fallen 25 percent as of January 2017. Puerto Rico's banks have also struggled, as several have shut down entirely. As a consequence of the struggles in Puerto Rico's banking and housing sectors, Puerto Rico has less capital, which may inhibit economic growth, according to some experts on Puerto Rico's economy.

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### **Factors that Enabled Puerto Rico to Use Debt to Finance Operations**

To cope with its persistent deficits, Puerto Rico issued debt to finance operations. In reviewing 20 of Puerto Rico's largest bond issuances from 2000 to 2017, totaling around \$31 billion, we found that 16 were issued exclusively to repay or refinance existing debt and to fund operations.<sup>54</sup> According to ratings agency officials and experts in state and local government, states rarely issue debt to fund operations, and many states prohibit this practice. According to former Puerto Rico officials and experts on Puerto Rico's economy, high demand for Puerto Rico debt and the Government Development Bank for Puerto Rico (GDB) facilitating

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<sup>53</sup>GAO, *Tax Policy: Puerto Rico and the Section 936 Tax Credit*, GAO/GGD-93-109 (Washington, D.C.: June 1993).

<sup>54</sup>Three bond issuances were used for a combination of repayment and refinancing existing debt, funding for operations, and capital projects. Only one issuance was exclusively dedicated to new capital projects.

rising debt levels enabled Puerto Rico to continue to use debt to finance operations.

#### High Demand for Puerto Rico Debt

Puerto Rico issued a relatively large amount of debt, given the size of its population. Based on an analysis of fiscal year 2014 comprehensive annual financial reports of the 50 states and Puerto Rico, Puerto Rico had the second highest amount of outstanding debt among states and territories,<sup>55</sup> while its population falls between the 29th and 30th most populous states. By comparison, California, the state with the largest amount of outstanding debt, is the most populated state.<sup>56</sup> Various factors drove demand for Puerto Rico municipal bonds, even as the government's financial condition deteriorated.

- **Triple tax exemption:** According to a former Puerto Rico official, Federal Reserve Bank of New York officials, and an expert on Puerto Rico's economy, Puerto Rico's municipal bonds were attractive to investors because interest on the bonds was not subjected to federal, state, or local taxes, regardless of where the investors resided.<sup>57</sup> In contrast, investors may be required to pay state or local taxes on interest income earned from municipal securities issued by a state or municipality in which they do not reside.
- **Investment grade bond ratings:** Puerto Rico maintained investment grade bond ratings until February 2014, even as its financial condition was deteriorating.<sup>58</sup> Credit ratings inform investment decisions by both institutional investors and broker dealers. According to a current Puerto Rico official and an expert on Puerto Rico's economy, investment grade ratings for Puerto Rico municipal bonds may have

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<sup>55</sup>Debt data from Mercatus Center at George Washington University, *Ranking the States by Fiscal Condition 2016 Edition* (Arlington, Virginia: June 2016).

<sup>56</sup>Population estimates are according to Census as of July 1, 2017.

<sup>57</sup>48 U.S.C. § 745—Tax Exempt Bonds—states that all bonds issued by the Government of Puerto Rico, or by its authority, shall be exempt from taxation by the Government of the United States, or by the Government of Puerto Rico or of any political or municipal subdivision thereof, or by any State, Territory, or possession, or by any county, municipality, or other municipal subdivision of any State, Territory, or possession of the United States, or by the District of Columbia.

<sup>58</sup>In February 2014, three rating agencies downgraded Puerto Rico's general obligation debt to speculative, or noninvestment grade, because of concerns over Puerto Rico's reliance on market access for liquidity and the use of deficit financing.

driven demand for these securities in the states.<sup>59</sup> Based on interviews with ratings agency officials and a review of rating agency criteria, we found that Puerto Rico may have maintained its investment grade rating for two reasons. First, Puerto Rico could not seek debt restructuring under federal bankruptcy laws, prior to the passage of PROMESA in 2016. According to rating agency officials, bonds with assumed bankruptcy protection tend to rate higher than those without such protection. Second, legal frameworks that prioritize debt service are often viewed as positive for credit ratings, according to rating agency criteria. In the event that the Puerto Rico government does not have sufficient resources to meet appropriations for a given fiscal year, Puerto Rico's constitution requires that the government pay interest and amortization on the public debt before disbursing funds for other purposes in accordance with the order of priorities established by law.<sup>60</sup> The prior Puerto Rico Governor cited this constitutional provision as providing the authority to redirect revenue streams from certain entities to the payment of general obligation debt.<sup>61</sup> This redirection of revenue streams is commonly known as a clawback.<sup>62</sup>

- **Lack of transparency on its financial condition:** Municipal market analysts told us that untimely financial information made it difficult for institutional and individual investors to assess Puerto Rico's financial condition, which may have resulted in investors not being able to fully take the investment risks into account when purchasing Puerto Rico debt. According to one report, between 2010 and 2016 municipal issuers issued their audited financial statements an average of 200 days after the end of their fiscal years.<sup>63</sup> However, between fiscal years 2002 and 2014, Puerto Rico issued its statements an average of 386 days after the end of its fiscal year, according to our analysis of Puerto Rico's audited financial statements. Moreover, Puerto Rico

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<sup>59</sup>Puerto Rico's issued \$3.5 billion in general obligation bonds in March 2014, after the February downgrade. This issuance attracted largely non-traditional investors such as hedge funds and paid a very high interest rate.

<sup>60</sup>P.R. Const., art. VI, § 8.

<sup>61</sup>P.R. Executive Order OE-2015-046 (Nov. 30, 2015).

<sup>62</sup>For some agencies, such as Puerto Rico's Highway and Transportation Authority and the Puerto Rico Industrial Financing Authority, revenue clawbacks limited their ability to satisfy their own obligations to lenders.

<sup>63</sup>Municipal Securities Rulemaking Board, *Timing of Annual Disclosures by Issuers of Municipal Securities* (Washington, D.C.: Feb. 2017).

had not issued its fiscal years 2015 and 2016 audited financial statements as of March 1, 2018, or 975 and 609 days after the end of those fiscal years, respectively.<sup>64</sup>

- Estate tax structures: Puerto Rico residents had incentive to invest in municipal bonds issued in Puerto Rico over those issued in the United States because of federal and Puerto Rico estate tax structures. Current and former Puerto Rico officials told us that this incentive drove demand among Puerto Rico residents for bonds issued in Puerto Rico. For federal estate tax purposes, Puerto Rico residents are generally considered non-U.S. residents and non-citizens for all of their U.S.-based property, including investments.<sup>65</sup> Estates of Puerto Rico residents are required to pay the prevailing federal estate tax—which ranges from 18 percent to 40 percent depending on the size of an estate—for any U.S.-based property valued over \$60,000.<sup>66</sup> In contrast, prior to 2017, all Puerto Rico-based property was only subject to the Puerto Rico estate tax of 10 percent. Puerto Rico's estate tax was repealed in 2017.

#### Puerto Rico's Government Development Bank Facilitated Rising Debt Levels

In addition to financing from the municipal bond markets, GDB also provided an intragovernmental source of financing. Prior to April 2016, GDB acted as a fiscal agent, trustee of funds, and intergovernmental lender for the Government of Puerto Rico.<sup>67</sup> GDB issued loans to Puerto Rico's government agencies and public corporations to support their operations. GDB provided loans to government entities valued at up to 60

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<sup>64</sup>According to current Puerto Rico officials, reasons for the late financial statements include challenges related to Hacienda needing to reassess the value of GDB deposits that were reflected in Puerto Rico component units' audited financial statements—which are prepared earlier than the comprehensive audited financial statements and by different auditors—when no assets backed the deposits; translation challenges; and trying to adhere to new accounting standards.

<sup>65</sup>26 U.S.C. § 2209.

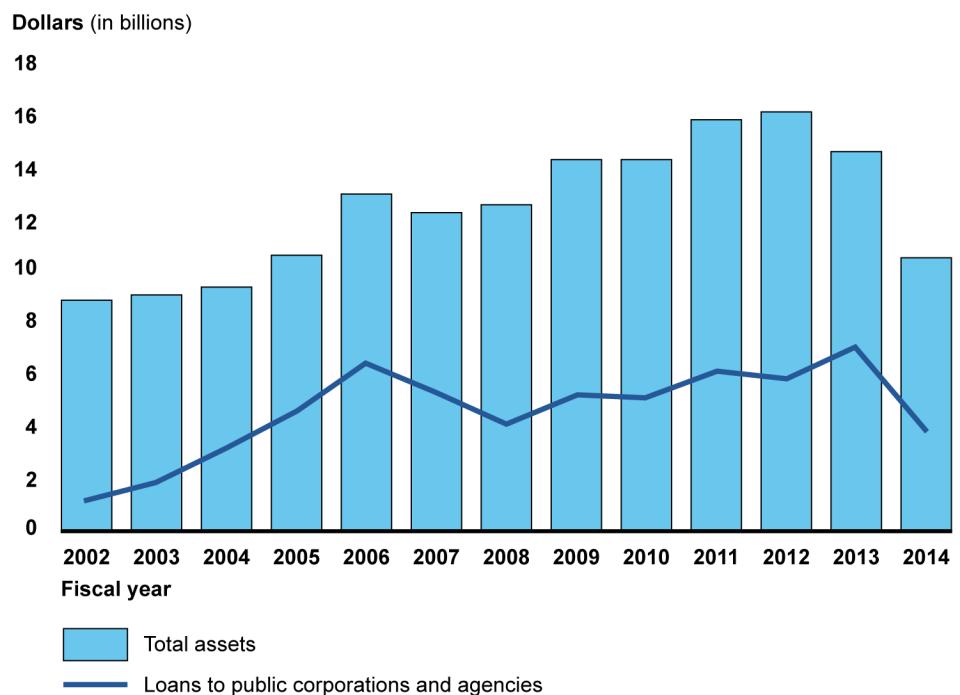
<sup>66</sup>26 U.S.C. §§ 2001, 2101.

<sup>67</sup>Prior to April 2016, GDB performed the following roles for the Puerto Rico Government and its entities: (1) fiscal agent, paying agent, financial advisor, and reporting agent; (2) depositary and trustee of funds; and (3) lender of money, with and without security, to the government, its entities, or to external parties including persons, firms, corporations or organizations. In April 2016, these responsibilities were transferred to the Fiscal Agency and Financial Advisory Authority (FAFAA), which was newly created under the Puerto Rico Emergency Moratorium and Financial Rehabilitation Act. FAFAA's powers were further expanded in January 2017 by the current governor to include collaboration with the Oversight Board as well as responsibility for negotiations with creditors regarding the debt of Puerto Rico's government and its entities.

percent of GDB's total assets, as shown in Figure 11. In general, these entities did not fulfill the terms of their borrowing agreements with GDB, while they independently accessed the municipal bond market.

Additionally, according to GDB's audited financial statements, GDB did not reflect loan losses in its audited financial statements until 2014 because it presumed that Puerto Rico's legislature would repay loans through the general fund or appropriations, as generally required by the acts that approved such loans.

**Figure 11: Puerto Rico Government Development Bank (GDB) Total Assets and Loans to Puerto Rico Agencies and Public Corporations**



Source: GAO analysis of Puerto Rico's fiscal year 2000 to 2015 audited financial statements. | GAO-18-387

Note: Loans to public corporations are presented as net of allowance for loan losses. Puerto Rico has not yet released its audited financial statements for fiscal years 2015, 2016 and 2017. According to current Puerto Rico officials, the Puerto Rico government plans to release its audited financial statements for fiscal years 2015 and 2016 by the end of June 2018. These officials also stated that the Puerto Rico government has not yet set a timeline for releasing audited financial statements for fiscal year 2017.

Facing non-repayment of public sector loans, GDB took on debt to maintain liquidity. According to GDB documents, repayment of amounts owed to GDB was a main reason for the creation of the Puerto Rico Sales Tax Financing Corporation (COFINA), an entity backed by a new sales tax, through which Puerto Rico issued some of its debt. Though initially intended as a means to repay GDB and other debt, COFINA bonds were also used to finance operations.

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## Actions That Could Address Factors that Contributed to Puerto Rico's Unsustainable Debt Levels

Through our interviews and an assessment of relevant literature, we identified three potential federal actions that could help address some of the factors that contributed to unsustainable indebtedness in Puerto Rico. Consistent with the provision in PROMESA that was the statutory requirement for this work, we focused on actions that were non-fiscal in nature—that is, actions that would not increase the federal deficit. There are tradeoffs for policymakers to consider when deciding whether or how to implement any policy. For each action, we describe a specific challenge as it relates to debt accumulation in Puerto Rico, identify a possible federal response to the challenge, and describe other considerations for policymakers.

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### Action 1: Modify SEC's Authority over Municipal Securities Disclosure Requirements

To help address the factors that contributed to the high demand for Puerto Rico debt relative to other municipal debt, legislative and executive branch policymakers could further ensure that municipal securities issuers provide timely, ongoing, and complete disclosure materials to bondholders and the public. Specifically, Congress could authorize SEC to establish requirements for municipal issuers on the timing, frequency, and content of initial and continuing disclosure materials.<sup>68</sup>

#### Challenge

In general, the municipal securities market is less regulated and transparent than other capital markets, such as equity markets. For example, SEC's authority to directly establish or enforce initial and continuing disclosure requirements for issuers—including those in Puerto

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<sup>68</sup>Initial disclosure is information provided to investors when securities are issued, primarily in an official statement. Continuing disclosure is information provided to investors in the secondary market, where these securities are bought and sold after issuance, and can include financial statements and other financial and operating information. SEC proposed this legislative change in a 2012 report. See SEC, *Report on the Municipal Securities Market* (Washington D.C.: July 2012).

Rico—is limited.<sup>69</sup> SEC requires that underwriters (sellers of municipal securities) reasonably determine that issuers have undertaken continuing disclosure agreements (CDA) to publicly disclose ongoing annual financial information, operating data, and notices of material events.<sup>70</sup> However, federal securities laws do not provide SEC with the authority to impose penalties on municipal issuers for noncompliance with CDAs, which may limit any incentive for issuers to comply with SEC disclosure and reporting guidance.<sup>71</sup> As a result, SEC has limited ability to compel issuers to provide continuing disclosure information.

As previously discussed, the Puerto Rico government often issued its audited financial statements in an untimely manner, thus failing to meet its contractual obligations to provide continuing disclosures for securities it issued. SEC could not directly impose any consequences on Puerto Rico's government for failing to adhere to the terms of, or enforce compliance with, the CDAs. Additionally, as previously discussed, municipal market analysts told us that untimely financial information made it difficult for institutional and individual investors to assess Puerto Rico's financial condition.

## Addressing the Challenge

Timely disclosure of information would help investors make informed decisions about investing in municipal securities and help protect them against fraud involving the securities. These disclosures would be made to investors at the time of purchasing securities and throughout the term of the security, including when material changes to an issuer's financial condition occur. According to SEC staff, enhanced authority could prompt more municipal issuers to disclose financial information, including audited financial statements, in a timelier manner. For example, SEC staff said that if the agency had required that issuers provide timely financial

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<sup>69</sup>According to a 1975 Senate report, congressional reasons for the decision to limit direct regulation of issuers included respect for the rights of state governments to access the capital markets, concerns about the costs of regulation for state and local government issuers, and the perceived lack of abuses in the municipal market that would justify such an incursion on the states' prerogatives. S. Rep. No. 94-75 (1975).

<sup>70</sup>According to SEC, if an issuer does not comply with the terms of a continuing disclosure agreement, an underwriter may refuse to participate in a future bond offering with that issuer and bondholders may bring lawsuits against the issuers.

<sup>71</sup>In 2012, we reported that SEC could use its antifraud authority to encourage issuers to comply with their continuing disclosure agreements. See GAO, *Municipal Securities: Options for Improving Continuing Disclosure*, GAO-12-698 (Washington, D.C. July 19, 2012). SEC staff also told us that the agency has used its antifraud authority to indirectly enforce the terms of continuing disclosure agreements.

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statements at the time of issuing a municipal security, this may have precluded Puerto Rico from issuing its \$3.5 billion general obligation bond in 2014. However, any rulemaking SEC would or could take as a result of enhanced authority would depend on a number of factors, such as compliance with other SEC guidance and related laws.

#### Other Considerations

Since this action would apply to all U.S. municipal securities issuers, it has policy and implementation implications that extend well beyond Puerto Rico. For example, establishing and enforcing initial and continuing disclosure requirements for municipal securities issuers could place additional burdens on state and local issuers, and not all municipal issuers use standardized accounting and financial reporting methods. As a result, state and local governments may need to spend resources to adjust financial reporting systems to meet standardized reporting requirements. However, in a 2012 report proposing this action, SEC said it could mitigate this burden by considering content and frequency requirements that take into account, and possibly vary by, the size and nature of the municipal issuer, the frequency of issuance of securities, the type of municipal securities offered, and the amount of outstanding securities.

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#### Action 2: Apply Federal Investor Protection Laws to Puerto Rico

To help address the factors that contributed to the high demand for Puerto Rico debt relative to other municipal debt, Congress could ensure that investors residing in Puerto Rico receive the same federal investor protections as investors residing in states. Specifically, Congress could subject all investment companies in Puerto Rico to the Investment Company Act of 1940, as amended (1940 Act). In recent years, the House and Senate separately have passed legislation that would achieve this action.<sup>72</sup>

#### Challenge

Certain investment companies in Puerto Rico and other territories—specifically, those whose securities are sold solely to the residents of the territory in which they are located—are exempt from the 1940 Act's

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<sup>72</sup>For example, during the 115<sup>th</sup> Congress, the House passed H.R. 1366 on May 1, 2017 and the Senate passed S.484 on September 11, 2017 and S.2155 on March 14, 2018. All three bills would subject all investment companies in Puerto Rico to the 1940 Act.

requirements.<sup>73</sup> The 1940 Act regulates investment companies, such as mutual funds that invest in securities of other issuers and issue their own securities to the investing public. It imposes several requirements on investment companies intended to protect investors. For example, it requires that investment companies register with SEC and disclose information to investors about the businesses and risks of the companies in which they invest, and the characteristics of the securities that they issue. It also restricts investment companies from engaging in certain types of transactions, such as purchasing municipal securities underwritten by affiliated companies.<sup>74</sup>

According to a former Puerto Rico official, some broker-dealers in Puerto Rico underwrote Puerto Rico municipal securities issuances and investment companies managed by affiliated companies of these underwriters purchased the securities, packaged them into funds, and marketed the funds to investors residing in Puerto Rico. This practice would be prohibited or restricted for investment companies subject to the 1940 Act, as it might result in investment companies not acting in the best interests of their investors.

#### Addressing the Challenge

If all Puerto Rico investment companies had been subject to the 1940 Act, they would have been prohibited or restricted from investing in Puerto Rico municipal bonds underwritten by affiliated companies. Also, these investment companies may have further disclosed the risks involved in Puerto Rico municipal bonds to Puerto Rico investors.<sup>75</sup> As a result, demand for Puerto Rico municipal bonds from Puerto Rico investment companies and residents may have been lower had the 1940 Act requirements applied to all Puerto Rico investment companies, and it

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<sup>73</sup>The financial institutions excluded from the 1940 Act are those organized or otherwise created under the laws of and having its principal office and place of business in Puerto Rico or other territories. 15 U.S.C. § 80a-6(a)(1). According to a House Financial Services Committee report, in 1940, it was prohibitively expensive and logistically difficult for U.S. officials to travel to, and inspect investment companies in, Puerto Rico given its geographic location. This reason may no longer be valid, given modern means of transportation.

<sup>74</sup>In general, an affiliated company includes an entity that controls, is controlled by, or is under common control with the investment company. 15 U.S.C. § 80a-2(a)(2), (3).

<sup>75</sup>According to SEC staff, even though certain Puerto Rico investment companies are not subject to the 1940 Act, they are subject to Puerto Rico investment company laws. According to the staff, these laws are modeled, to some extent, on the 1940 Act. However, the staff did not know the extent of any disclosure requirements within those laws, as they do not administer Puerto Rico's laws.

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may have been more difficult for the Puerto Rico government to issue debt to finance deficits.

#### Other Considerations

SEC staff told us that industry groups had raised objections to extending the 1940 Act provisions to all investment companies in Puerto Rico. These industry groups noted that, among other things, certain investment companies would have difficulty meeting the 1940 Act's leverage and asset coverage requirements and adhering to some restrictions on affiliated transactions. However, SEC staff noted that under certain legislation that passed the House or Senate separately, as described above, Puerto Rico investment companies would have three years to come into compliance if they were newly subject to the 1940 Act. Further, under that legislation, after three years, investment companies in Puerto Rico could also request an additional three years to come into compliance. Regarding affiliated company restrictions, SEC has previously waived some requirements for investment companies if they are unable to obtain financing by selling securities to unaffiliated parties with an agreement to repurchase those securities at a higher price in the future, known as repurchase agreements. According to SEC staff, SEC would consider allowing companies in Puerto Rico to enter into reverse repurchase agreements with their affiliates if the 1940 Act applied to them.

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#### Action 3: Modify the Tax Exemption Status for Puerto Rico Municipal Securities

To help address the factors that contributed to the high demand for Puerto Rico debt relative to other municipal debt, Congress could remove the triple tax exemption for Puerto Rico's municipal securities. This action would mean that interest income from Puerto Rico municipal securities earned by investors residing outside of Puerto Rico could be taxed by states and local governments, while still being exempt from federal income taxes, similar to the current tax treatment of municipal bond income in the states.<sup>76</sup>

#### Challenge

As mentioned previously, former Puerto Rico officials and experts in municipal securities told us that the triple tax exemption fueled investor demand and enabled Puerto Rico to continue issuing bonds despite deteriorating financial conditions.<sup>77</sup> Some of the demand for Puerto Rico

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<sup>76</sup>Some states and municipalities do not levy state and local personal income taxes, respectively.

<sup>77</sup>The relatively higher return on Puerto Rico bonds compared to bonds issued in the states may have also driven demand for Puerto Rico bonds.

municipal securities came from certain U.S. municipal bond funds. These funds concentrated their investments in one state to sell to investors within that state, but also included Puerto Rico bonds in their portfolios. Puerto Rico bond yields generally were higher than state bonds yields, according to industry experts.<sup>78</sup> When added to a fund, the higher yields from Puerto Rico bonds would increase the overall return on investment yield of a fund.

#### Addressing the Challenge

Modifying the triple tax exemption for Puerto Rico's municipal securities might result in reduced demand for Puerto Rico's debt. In response to reduced demand for its debt, Puerto Rico's government may need to address any projected operating deficits by decreasing spending, raising revenues, or both.

#### Other Considerations

According to U.S. Treasury officials, this action could increase the proportionate share of investors in Puerto Rico debt that reside in Puerto Rico, because of reduced demand from investors in the states. In the event of a future debt crisis, this could result in a concentration of financial losses within Puerto Rico. Also, debt financing allows governments to make needed capital investments and provides liquidity to governments, and can be a more stable funding source to manage fiscal stress. Reduced market demand for Puerto Rico's bonds could make access to debt financing difficult, as the Puerto Rico bond market may not support the Puerto Rico government's future borrowing at reasonable interest rates, according to Treasury officials.<sup>79</sup> Alternately, a variant of this action would be to retain the triple tax exemption for Puerto Rico debt only for bonds related to capital investments rather than for deficit financing, according to Treasury officials.<sup>80</sup>

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<sup>78</sup>For example, one municipal bond fund that invested in Maryland municipal securities held 37.5 percent of its net assets in Puerto Rico and other territorial municipal bonds as of March 31, 2017. SEC staff told us that they had reached out to some mutual funds to ensure they were disclosing their Puerto Rico municipal bond holdings appropriately, but that the agency did not otherwise identify problems.

<sup>79</sup>One purpose of the Oversight Board is to provide Puerto Rico a method for accessing capital markets; it terminates upon a certification that Puerto Rico has access to capital markets at reasonable rates to meet its borrowing needs, among other things.

<sup>80</sup>Currently, a securities issuer's bond counsel—a legal counsel retained by the issuer to confirm that the bonds have been validly issued, among other things—already certifies whether or not the bonds are tax exempt. According to Treasury officials, an issuer's bond counsel could also be required to certify how Puerto Rico intended to use bond proceeds.

## Other Federal Actions Taken to Address Puerto Rico's Fiscal Condition

Various provisions in PROMESA were intended to help Puerto Rico improve its fiscal condition. PROMESA requires that the Oversight Board certify fiscal plans for achieving fiscal responsibility and access to capital markets. The intent of the fiscal plans is to eliminate Puerto Rico's structural deficits; create independent revenue estimates for the budget process; and improve Puerto Rico's fiscal governance, accountability, and controls, among other things. From March 2017 to April 2017, the Oversight Board certified the fiscal plans the Government of Puerto Rico developed for the primary government and certain component units, such as PREPA. As a result of the effects of Hurricanes Irma and Maria, the Oversight Board requested that the Government develop updated fiscal plans. Although the Government of Puerto Rico developed and submitted updated fiscal plans, the Oversight Board did not certify them, with the exception of the plan for GDB. Instead, in April 2018, the Oversight Board certified fiscal plans it developed itself, as PROMESA allows.<sup>81</sup> PROMESA also requires the Oversight Board to determine whether or not Puerto Rico's annual budgets, developed by the Governor, comply with the fiscal plans prior to being submitted to Puerto Rico's legislature for approval.

Technical assistance is another area where the federal government has taken action to help Puerto Rico address its fiscal condition. In 2015, Congress first authorized Treasury to provide technical assistance to Puerto Rico, and has continued to reauthorize the technical assistance, most recently through September 30, 2018.<sup>82</sup> For example, Treasury officials told us that they helped Puerto Rico's Planning Board develop a more accurate macroeconomic forecast, which should enable Hacienda

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<sup>81</sup>PROMESA outlines three means by which a fiscal plan can be certified as compliant: (1) by the Oversight Board approving a plan submitted by the Governor, (2) by the Oversight Board developing its own plan, or (3) by the Oversight Board and the Governor jointly developing a plan. PROMESA, § 201(d)(2).

<sup>82</sup>Authorization was first provided in the Consolidated Appropriations Act, 2016. Pub. L. No. 114-113, div. E, 129 Stat. 2242, 2423 (Dec. 18, 2015). The most recent authorization was provided in the Consolidated Appropriations Act, 2018. Pub. L. No. 115-141, div. E, title I, 132 Stat. 348, \_\_\_\_ (Mar. 23, 2018).

to develop more accurate revenue estimates and receipt forecasts.<sup>83</sup> Treasury officials also told us that the agency began helping Puerto Rico improve its collection of delinquent taxes—for example, by helping Hacienda develop an office dealing with Puerto Rico’s largest and most sophisticated taxpayers, which are often multinational corporations. With Puerto Rico focused on hurricane recovery efforts, Treasury and the Puerto Rico government are reassessing the types of assistance that Treasury might provide in the future, according to Treasury officials.

Current and former Puerto Rico government officials and experts on Puerto Rico’s economy also told us that the federal government could further help Puerto Rico address its persistent deficits through federal policy changes that are fiscal in nature. For example, it could change select federal program funding rules—at a cost to the federal government—such as eliminating the cap on Medicaid funding and calculating the federal matching rate similar to how the rate is calculated in the states. Likewise, the Congressional Task Force on Economic Growth in Puerto Rico (Congressional Task Force), as established by PROMESA, issued a report in December 2016 that recommended changes to federal laws and programs that would spur sustainable long-term economic growth in Puerto Rico, among other recommendations.

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### Puerto Rico Plans to Take Actions to Address Its Fiscal Condition and Debt Levels

In addition to federal actions that could address the factors that contributed to Puerto Rico’s fiscal condition and debt levels, the Puerto Rico government plans to take various actions. For example, according to current Puerto Rico officials and the Puerto Rico government’s April 2018 fiscal plan, the government is:

- Planning to implement an integrated new information technology system for financial management, to include modernized revenue management and accounting and payroll systems. Hacienda officials stated that they are in the process of developing a project schedule for this long-term effort.
- Developing a new public healthcare model in which Puerto Rico’s government pays for basic services and patients pay for premium

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<sup>83</sup>Despite these improvements, experts in Puerto Rico’s economy told us that other macroeconomic variables measured by the Planning Board, such as actual GDP, used outdated methods. A 2016 Congressional Task Force recommended that the Department of Commerce’s Bureau of Economic Analysis (BEA) calculate GDP for Puerto Rico as it does for the other territories; BEA’s strategic plan includes this objective.

services. The government will begin implementing the new healthcare model in fiscal year 2019 and expects to achieve annual savings of \$841 million by fiscal year 2023.

- Collaborating with the private sector for future infrastructure and service projects, including for reconstruction efforts related to Hurricanes Irma and Maria, which it expects will stimulate Puerto Rico's weakened economy.

We also asked Puerto Rico officials about progress made toward addressing many of the factors we identified. However, they did not provide us this information.

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## Agency Comments, Third Party Views, and Our Evaluation

We provided a draft of this report for review to Treasury, SEC, the Federal Reserve Bank of New York, the Government of Puerto Rico, and the Oversight Board. Treasury and SEC provided technical comments, which we incorporated as appropriate. The Federal Reserve Bank of New York and the Oversight Board had no comments.

We received written comments from the Government of Puerto Rico, which are reprinted in appendix II. In its comments, the Government of Puerto Rico generally agreed with the factors we identified that contributed to Puerto Rico's financial condition and levels of debt. It also provided additional context on Puerto Rico's accumulation of debt, such as Puerto Rico's territorial status and its effect on federal programs in Puerto Rico and outmigration.

The Government of Puerto Rico also noted that the federal actions we identified to address factors contributing to Puerto Rico's unsustainable debt levels did not include potential actions that were fiscal in nature or that addressed Puerto Rico's long-term economic viability. As we note in the report, we excluded fiscal actions from our scope, consistent with the provision in PROMESA that was the statutory requirement for this work. We excluded potential actions that could promote economic growth in Puerto Rico because these actions would address debt levels in Puerto Rico only indirectly and because the Congressional Task Force on Economic Growth in Puerto Rico already recommended actions for fostering economic growth in Puerto Rico in its December 2016 report.

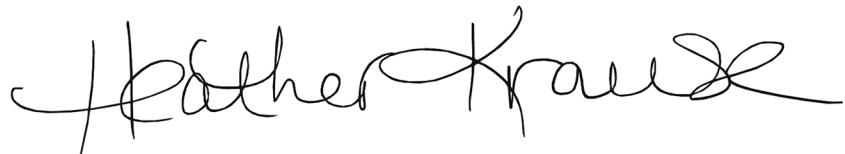
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We are sending copies of the report to the appropriate congressional committees, the Government of Puerto Rico, the Secretary of the Treasury, the Chairman of the Securities and Exchange Commission, and

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other interested parties. In addition, this report is available at no charge on the GAO website at <http://gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-6806 or [krauseh@gao.gov](mailto:krauseh@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix III.



Heather Krause  
Director, Strategic Issues

# Appendix I: Objectives, Scope, and Methodology

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Our objectives were to describe (1) the factors that contributed to Puerto Rico's financial condition and levels of debt; and (2) federal actions that could address the factors that contributed to Puerto Rico's financial condition and levels of debt. Consistent with the provision in the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) that was the statutory requirement for this work, we focused on actions that would not increase the federal deficit.

For both objectives we interviewed current Puerto Rico officials from several agencies—the Puerto Rico Department of Treasury (Hacienda in Spanish), Government Development Bank for Puerto Rico (GDB), the Puerto Rico Office of Management and Budget (Spanish acronym OGP), Fiscal Agency and Financial Advisory Authority (FAFAA), and the Puerto Rico Electric Power Authority. We also interviewed 13 former Puerto Rico officials that held leadership positions at Hacienda, GDB, or OGP, or a combination thereof. These former officials served between 1997 and 2016 for various gubernatorial administrations associated with the two political parties in Puerto Rico that held the governorship during that period.<sup>1</sup> We also interviewed officials from the U.S. Department of the Treasury (Treasury), the Securities and Exchange Commission (SEC), the Federal Reserve Bank of New York, and the Financial Oversight and Management Board for Puerto Rico (created by PROMESA). Additionally, we conducted another 13 interviews with experts on Puerto Rico's economy, the municipal securities markets, state and territorial budgeting and debt management—including credit rating agencies—and with select industry groups in Puerto Rico. We selected the experts we interviewed based on their professional knowledge closely aligning with our engagement objectives, as demonstrated through published articles, congressional testimonies, and referrals from agency officials or other experts.

To describe the factors that contributed to Puerto Rico's financial condition and levels of debt, we reviewed our prior work related to Puerto Rico's financial condition and levels of public debt. We also collected and analyzed additional financial data from Puerto Rico's audited financial statements for the fiscal years 2002 to 2014, the last year for which

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<sup>1</sup>The two political parties in Puerto Rico that held the governorship from 1997 to 2016 are the Popular Democratic Party and New Progressive Party. The current governor is from the New Progressive Party.

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audited financial statements were available.<sup>2</sup> To determine how the Puerto Rico government used bond proceeds, we reviewed a nongeneralizable sample of Puerto Rico bonds prospectuses issued between 2000 and 2017 from the Electronic Municipal Market Access database of the Municipal Securities Rulemaking Board.

We reviewed literature—including academic reports, congressional hearing transcripts, and credit rating agency reports—that described Puerto Rico’s economy and factors that contributed to Puerto Rico’s levels of debt. We also reviewed credit rating agency reports that described Puerto Rico’s municipal debt and the agencies’ methodologies for rating municipal debt. We also collected and reviewed Puerto Rico government documents related to budget formulation and execution, debt issuance, and financial management. We considered factors to include, but not be limited to, macroeconomic trends, federal policies, and actions taken by Puerto Rico government officials. Our review focused largely, though not exclusively, on conditions that contributed to the debt crisis during those years for which we collected financial data on Puerto Rico, fiscal years 2002 to 2014.<sup>3</sup>

Finally, we also conducted a thematic analysis of the summaries of our interviews to identify common patterns and ideas. Although these results are not generalizable to all current and former officials and experts with this subject-matter expertise, and do not necessarily represent the views of all the individuals we interviewed, the thematic analysis provided greater insight and considerations for the factors we identified.

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<sup>2</sup>For each fiscal year, we found that Puerto Rico’s independent auditor issued an unmodified opinion for the primary government and component units on its audited financial statements, meaning that the auditor concluded that they were presented fairly, in all material respects, in accordance with generally accepted accounting principles. In the fiscal year 2014 audited financial statement, the independent auditor’s letter also referenced uncertainty about Puerto Rico’s primary government and certain component units’ ability to continue as a going concern. According to current Puerto Rico officials, the Puerto Rico government plans to release its audited financial statements for fiscal years 2015 and 2016 by the end of June 2018. These officials also stated that the Puerto Rico government has not yet set a timeline for releasing audited financial statements for fiscal year 2017.

<sup>3</sup>We decided to begin our review with fiscal year 2002 because beginning in that fiscal year, Puerto Rico began reporting financial information in conformity with several government accounting standards the Governmental Accounting Standards Board adopted in 1999. Information collected from consolidated audited financial statements prior to 2002 would not readily compare to information collected on or after 2002.

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To describe federal actions that could address the factors that contributed to Puerto Rico's financial condition and levels of debt, we reviewed our prior reports and documents from Treasury and SEC, conducted a literature review, and conducted various interviews. Specifically, we met with federal agencies with subject-matter expertise or whose scope of responsibilities related to these actions, as well as with current and former Puerto Rico officials and municipal securities experts. Consistent with PROMESA, we omitted from our scope: (1) actions that could increase the federal deficit (i.e., fiscal options), (2) actions that could be taken by the Puerto Rico government, (3) actions that could infringe upon Puerto Rico's sovereignty and constitutional parameters, and (4) actions that would imperil America's homeland and national security.<sup>4</sup> We considered actions that could promote economic growth in Puerto Rico as outside of scope, as they could address debt levels in Puerto Rico indirectly, rather than directly, and because a study issued by the Congressional Task Force on Economic Growth in Puerto Rico already identified actions that Congress and executive agencies could take to foster economic growth in Puerto Rico.<sup>5</sup> We also considered actions that could address Puerto Rico's unfunded pension liability as outside of our scope. The actions we identified may also help avert future unsustainable debt levels in other territories; however, we did not assess whether and how each action would apply to other territories.

We conducted this performance audit from January 2017 to May 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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<sup>4</sup>For example, we excluded from our scope changes to mandatory federal spending programs, for which federal spending is determined by rules for eligibility, benefit formulas, and other parameters. Examples of mandatory spending programs include Medicaid, Medicare, Social Security, and the Supplemental Nutrition Assistance Program.

<sup>5</sup>Economic growth can increase a government's tax revenues and thus it may limit or prevent indebtedness. See Congressional Task Force on Economic Growth in Puerto Rico, *Report to the House and Senate* (December 20, 2016).

# Appendix II: Comments from the Government of Puerto Rico



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April 23, 2018

The Honorable Gene L. Dodaro  
Comptroller General of the United States  
U.S. General Accountability Office  
441 G Street, N.W.  
Washington, DC 20548

Dear Mr. Dodaro,

I am writing with regards to the U.S. Government Accountability Office (GAO) report, GAO-18-387, *PUERTO RICO Factors Contributing to the Debt Crisis and Potential Federal Actions to Address Them*. Thank you for the opportunity to review and comment on the report in draft form. This report will inform the public policy debate surrounding issues of critical importance to Puerto Rico.

Below are the official comments and feedback of the Government of Puerto Rico.

#### **Taking Responsibility for the Past and Making Meaningful Change for the Future**

- **Recognition of Local Responsibility for Past Actions:** The Government of Puerto Rico recognizes and acknowledges that in the past decades there have been a number of locally formulated practices, policy decisions and failures of government administration that have severely impacted Puerto Rico's fiscal and debt situation in negative ways. The GAO report does a good job of identifying many of these factors which have occurred during previous administrations, and as most, if not all, of the tables and data utilized in the report show, they reflect what has happened prior to the current term of government on the island and not what is currently taking place or the changes still being implemented.
- **Actions by Current Administration to Address Local Factors:** Since taking office in 2017 the Governor of Puerto Rico, Hon. Ricardo Rosselló, has demonstrated a clear commitment to correcting these past practices, policies and failures of government administration to stabilize Puerto Rico's finances and set the island on a path to sustainable economic recovery and revitalization. While the complete enumeration of these actions is not possible within the confines of this letter, we recommend that GAO reference the *New Fiscal Plan for Puerto Rico*, which was made public on April 5, 2018, as part of the efforts to comply with P.L. 114-187, the Puerto Rico Oversight, Management and Economic Stability Act of 2016 (PROMESA). The main elements of this plan address the need to: establish a new vision for Puerto Rico's socioeconomic model; rebuild Puerto Rico after Hurricanes Irma and Maria; forge a path to structural balance in our economy and finances; transform local government to improve efficiency and effectiveness; and, carry out structural reforms to build on Puerto Rico's strengths and core competencies.

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- **Process of Change and Transformation:** The GAO must recognize that almost the totality of the government reforms and transformations taking place in Puerto Rico right now are focused on addressing factors that contributed to Puerto Rico's unsustainable and excessive debt. However, change is not automatic and requires sustained effort and close coordination and partnership between federal, state, local governments and all non-governmental stakeholders. Among the factors identified by GAO in this report that contributed to Puerto Rico's unsustainable debt, specific actions have been taken or are in the process of being implemented to address the following areas:
  - Inadequate Financial Management and Oversight Practices
    - Overestimation of Revenue Collections
  - Persistent Spending in Excess of Appropriated Amounts
  - Policy Decisions
    - Use of Debt Proceeds to Balance Budgets
    - Insufficiently Addressing Public Pension Funding Shortfalls
    - Inadequate Management of Puerto Rico Electric Power Authority's (PREPA) Financial Condition
    - Funding Public Health Care Coverage
  - Prolonged Economic Contraction
    - Puerto Rico's Outmigration and Diminished Labor Force
    - Regulatory Challenges of Doing Business in Puerto Rico
    - High Cost of Energy
    - Banking and Housing Struggles
  - Factors that Enabled Puerto Rico to Use Debt to Finance Operations
    - Transparency of Financial Conditions
    - Government Development Bank Role in Debt Issuance

**Federal Factors that Have Contributed to Puerto Rico's Unsustainable Debt Levels**

Beyond the mostly local factors identified in this report that have contributed to the excessive and unsustainable debt levels in Puerto Rico, GAO must also recognize the impact that the undemocratic, unequal and oftentimes arbitrary federal legal, regulatory and constitutional frameworks that apply to the island as a U.S. territory have had on this situation. Failure to do so, or underemphasizing them, obscures the root causes of Puerto Rico's financial and economic woes, and creates the risk that any actions GAO identifies to address the issue could be relatively superficial and insufficient given the complexity and scope of the problem. The following factors provide indispensable context within which Puerto Rico's excessive and unsustainable debt was accumulated, and provide a more complete frame of reference for the identification of federal actions that will result in meaningful positive long-term change in the fiscal and economic viability and sustainability of Puerto Rico.

- **Territorial Status Allows for Structural Inequality:** Under Puerto Rico's territorial status Congress can and does treat the island unequally under multiple federal laws, programs (such as Medicaid, Medicare, Highway funding, Earned Income Tax Credit), and many other policies. This means that the Government and People of Puerto Rico cannot count on the same

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amount of federal support that state governments and residents receive and are expected to perform economically in an uneven playing field. The inequitable policies also lead to an overall quality of life in Puerto Rico that is below the standard in the states in multiple respects. Given the mobility of Puerto Rico residents, which as U.S. citizens can travel freely between the island and the states, and the growing population of stateside Puerto Ricans, the voting population in the island is keenly aware of the discrepancy in quality of life. As one would expect from rational persons, voters in Puerto Rico aspire to attain a standard of living in the island equal to that afforded to our fellow citizens in the states. Therefore, the federally-created situation of structural inequality combined with citizen mobility, generates significant political pressure on Puerto Rico's elected officials to spend beyond the territory's means to meet the expectations and aspirations of the citizenry. While this does not make the decision to use debt spending to finance recurring deficits either good policy or a sustainable practice, it does show that this behavior is not happening in a vacuum. It has taken place within a framework of federal laws and policies that discriminate against U.S. citizens because of where they are born and or where they choose to live.

- **Unfunded Mandates Under Federal Laws and Regulations:** Another factor that must be considered is the imposition of federal laws and regulations that amount to unfunded mandates, where the Government of Puerto Rico is expected to make capital investments or provide certain services to its constituents, yet the level of federal support to accomplish these oftentimes laudable goals is woefully insufficient. Examples of this include the types of benefits that Puerto Rico is required to provide its Medicaid population, and the Environmental Protection Agency's Mercury and Air Toxic Standards emission standards that the Puerto Rico Electric Power Authority is required to meet under the Clean Air Act.
- **Current Federal Policy Contributes to Population Exodus:** While the mention of outmigration in the report is placed mostly in the context of the island's economic recession, there are multiple other factors of great significance that have spurred the current historic wave of migration of U.S. citizens moving from Puerto Rico to the states. These include citizens seeking full and equal treatment under federal laws and programs, citizens seeking full voting rights and representation in the federal government that makes the laws that they live under, and people seeking improved security, healthcare, and education which are unavailable to them in Puerto Rico because of the undemocratic and unequal treatment the island gets as a territory. The impact of this exodus goes beyond just a reduction in tax revenue. It also limits Puerto Rico's prospects for economic growth based on a reduced labor force as well as reduced aggregate demand within the local economy. The exodus also limits the island's ability to compete for new investments and economic opportunities. What these observations reveal is a self-reinforcing negative feedback loop where territorial inequality and a lack of cohesiveness in federal policies toward Puerto Rico limits the island's prospects for economic growth and encourages taking on excessive debt levels. This in turn spurs outmigration from the island which further erodes the economy, as well as the tax base, limiting the repayment capacity of the jurisdiction. This is particularly problematic because when Puerto Rico residents leave the

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island their share of the debt must be reallocated among the smaller population that remains behind, increasing the proportional share of debt per individual.

**Actions That Could Address Factors that Contributed to Puerto Rico's Unsustainable Debt Levels**

Given the insufficient emphasis on the fundamental structural causes that have led to Puerto Rico's unsustainable debt levels in the analysis presented by this report, we urge caution by the GAO and Congress as you consider potential federal actions to address the factors that have been identified. This is because if the actions proposed by GAO are limited to and focused on only addressing the symptoms of Puerto Rico's core issues they will not only miss the mark and fail to accomplish their objective, but could also result in damaging outcomes to the extent to which they give Congress the impression that they have taken care of what is needed while not having done anything of significance to address the root causes of Puerto Rico's economic and fiscal viability and sustainability. The Government of Puerto Rico also believes that only identifying possible federal actions that would not have a federal fiscal impact is an excessive constraint that severely limits the capacity of GAO to address the core issues in a meaningful way. For this reason, the Government of Puerto Rico will discuss possible federal actions that are not limited by this constraint.

- **Triple Tax-Exempt Status:** The Government of Puerto Rico is strongly opposed to the possible modification of the triple tax-exempt status for Puerto Rico's municipal debt. Although we recognize this was a factor that facilitated Puerto Rico's excessive indebtedness, the exemption, provided to Puerto Rico's bonds since the creation of its civil government in 1917, is also crucial to its efforts to overcome its current financial situation and provide for the sustainable development of the critical infrastructure that suffered widespread devastation because of the aftermath of hurricanes Irma and María. As GAO acknowledges, modifying this exemption could significantly increase the cost of borrowing for Puerto Rico impacting both its capacity to obtain needed liquidity and to make capital investments in the future. Indeed, limiting Puerto Rico's ability to obtain financing for necessary public works on favorable terms at this moment could condemn an Island that is struggling to recover from catastrophic hurricane damage to an unending cycle of economic stagnation. Additionally, given that in Sections 101, 201 and 209 of PROMESA Congress identified the reestablishment of access to capital markets for Puerto Rico as one of the core goals of the legislation, we believe that a modification of triple tax-exemption for our bonds would go directly against this core goal and could cause excessive delays in the completion of the process set forth under PROMESA. Given all the improvements in fiscal and budgetary controls, transparency and economic structural balance that are currently being implemented, the Government of Puerto Rico is confident that the triple tax-exempt bonding capacity can and will be used responsibly in the future when Puerto Rico is eventually able to return to the capital markets. Finally, although the triple tax-exempt status can be considered a benefit that the federal government grants the territories, its existence is attributable to some extent to the understanding by federal policymakers that the territory is subject to an unfair legal framework, particularly in terms of reduced levels of funding and various other areas of disadvantageous federal treatment. For

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this reason, until the federal government provides for Puerto Rico full equality under federal laws and programs, it should not remove one of the most important economic development tools and advantages that they have granted us.

- **Congressional & Executive Actions to Address Critical Challenges:** The report issued by the Congressional Task Force on Economic Growth in Puerto Rico in December 2016 identified a variety of policy recommendations for Congress and the federal Executive that could help address critical challenges in Puerto Rico and support the restoration of economic growth on the island. Whether Congress and the Executive work with the Government of Puerto Rico to act on the challenges and opportunities identified by the Task Force could make a very big difference in improving the conditions for economic growth to take place in the territory. Some of these challenges are well known in Congress and in the Executive and both have an immense impact on Puerto Rico's economic and fiscal prospects for the future. Among the most notable is the unequal treatment of Puerto Rico in federal Medicaid funding which periodically puts the stability of the island's entire healthcare system at risk and has contributed to a mass exodus of medical and health professionals which cannot be easily replaced. In this case Congress should work with Puerto Rico to establish a sustainable funding structure for our Medicaid program in a way that is tied to the levels of need, is means-tested and provides the same or better levels of care than the current unequal funding structure. Another notable challenge is the recent imposition of the Global Intangible Low-Taxed Income Tax (GILTI) on Puerto Rico as if we were foreign jurisdiction, whose impact on the manufacturing sector is projected to cause a very substantial reduction in local tax revenues. Congress should treat Puerto Rico as a domestic jurisdiction for purposes of GILTI in any upcoming legislative vehicle with tax provisions or technical fixes before the end of this year, and should work to improve upon Opportunity Zones to attract new private sector investment to the island. Other examples of policies that Congress could change to significantly improve Puerto Rico's economy and therefore our fiscal and debt outlook would be the full extension of the Child Tax Credit and the Earned Income Tax Credit to families on the island.
- **Resolution of Undemocratic & Unequal Territorial Status:** The question of Puerto Rico's ultimate political status and relationship with the Federal Government is intimately linked to the island's prospects for economic growth, and therefore its capacity to repay its debts. By allowing Congress and the federal Executive Branch to treat Puerto Rico differently and in ways that discriminate against the island and its residents, the current territorial status inherently limits economic growth. It does this by allowing the propagation of federal laws and policies toward the territory that lack the coherence and consistency required to provide for the island's sustained economic development and growth. The democratic deficit generated by the lack of voting representation at the federal level results in an inability of the elected officials from Puerto Rico to exert sufficient influence in the federal policy and regulatory making process to be able to ensure that the island's needs, conditions and aspirations are duly considered and accounted for. Unfortunately, federal policy towards the island is oftentimes executed as an afterthought and without a proper understanding of the circumstances of the island and its residents. There are countless examples of federal policies and practices that

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harm or limit Puerto Rico's economic development potential. Among these are the disparate treatment and sometimes-outright exclusion of Puerto Rico from a variety of federal programs, the island's exclusion from a multitude of federal studies and statistics, the disproportionately low level of federal procurement from businesses in Puerto Rico, and unnecessary regulations that limit interstate commerce such as the Electronic Export Information requirement. Another factor that negatively impacts the island's economy is the significant levels of political and policy uncertainty and risk created by the territorial status at both the local and federal levels. For businesses making investment decisions this political and policy risk decreases the desirability of making investments on the island and it also increases the borrowing cost for the government and private businesses on the island. The current reform process happening in Puerto Rico under PROMESA, and the post disaster reconstruction, present an ideal opportunity to finally define the ultimate political future of Puerto Rico, and to begin a transition toward that end. Congress must act definitively to resolve Puerto Rico's future political status, because extending the failed 120-year-old territory status will only further delay the island's full economic, fiscal and demographic recovery as well as its reconstruction. Congress must resolve Puerto Rico's status to unleash its full potential, and should implement the democratically expressed will of voters who have expressed twice in the last six years a clear desire to end the current territory status and to achieve statehood for Puerto Rico. Indeed, for America and Puerto Rico both, statehood is the best possible answer and the best path forward out of this century old issue and into a new century of economic growth and prosperity.

In closing, I want to thank GAO for its efforts in preparing this report. I hope that the comments contained here are helpful.

Sincerely,

Carlos R. Mercader Pérez, Esq.  
Executive Director  
Puerto Rico Federal Affairs Administration

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# Appendix III: GAO Contact and Staff Acknowledgments

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## GAO Contact

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## Staff Acknowledgments

In addition to the contact named above, Jeff Arkin (Assistant Director), Amy Radovich (Analyst in Charge), Pedro Almoguera, Karen Cassidy, Daniel Mahoney, A.J. Stephens, and Justin Snover made significant contributions to this report.

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